95-154

No. (2)

Supreme Court, U.S.
FILED
JUL 25 1995
CLERK

In The

Supreme Court of the United States

October Term, 1995

IN RE WORLDS OF WONDER SECURITIES LITIGATION

ROSETTA MILLER; WALTER UNTERMEYER; ALAN NISSELSON; TRUDY WHITMAN NISSELSON; PAUL GREENSTEIN; HOWARD H. WESTON, AS TRUSTEE FOR THE FLORIDA MUNICIPAL, INC., RESTATED DEFINED BENEFIT TRUST AND PLAN; and SYLVIA WIND, on behalf of themselves and the certified class of purchasers of the securities of Worlds of Wonder, Inc.,

Petitioners,

v.

ANGELO M. PEZZANI; DONALD D. KINGSBOROUGH; RICHARD B. STEIN; JOHN B. HOWENSTINE; BARRY H. MARGOLIS; DELOITTE & TOUCHE; SMITH BARNEY, HARRIS UPHAM & CO.; JOSEPHINE ABERCROMBIE; and WORLDS OF WONDER SHARES PARTNERSHIP,

Respondents.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Ninth Circuit

APPENDIX TO PETITION FOR WRIT OF CERTIORARI VOLUME II – App. 196 through App. 356

ALAN R. PLUTZIK
Counsel of Record
FARROW, BRAMSON, BASKIN & PLUTZIK
388 Market Street, Fifth Floor
San Francisco, CA 94111
Telephone: (415) 693-0400

ERNEST T. KAUFMANN
LAW OFFICES OF ERNEST T. KAUFMANN
2049 Century Park East
Suite 1100
Los Angeles, CA 90067

Co-Lead Counsel for Petitioners Rosetta Miller et al.

COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

164pp

Table of Contents for Appendix
to Petition for Writ of Certiorari

VOLUME I

DOCUMENT PAGE

Opinions and Orders Below

In Re Worlds of Wonder Securities Litigation, 35 F.3d 1407 (9th Cir. 1994).....App. 1

Order on Petition for Rehearing .....App. 50

Relevant Constitutional Statutory and Regulatory Provisions

U.S. Const. Amendment VII .....App. 52

Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k .....App. 53

Section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77*l*(2).....App. 60

Section 15 of the Securities Act of 1933, 15 U.S.C. § 77o ..... App 61

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b).....App. 62

Section 20(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78t .....App. 62

SEC Rule 10b-5, 17 C.F.R. § 240.10b-5.....App. 63

Fed. R. Civ. Proc. 56.....App. 64

Selected Evidence

Worlds of Wonder's Debenture Prospectus, June 4, 1987, ER 516 Ex. 23 .....App. 67

Table of Contents for Appendix – Continued

VOLUME II

PAGE

The Declaration of Albert Rossi, Jr., ER 522 . . . App. 196

WOW-K-Mart Letter Agreement bearing the date March 28, 1987, ER 516 Ex. 25 . . . . . App. 331

WOW Interoffice Memo dated June 29, 1987, from Dick Stein to Angelo Pezzani and Donald Kingsborough, ER 517 Ex. 27 . . . . . App. 341

May 6, 1987 Letter from K.A. MacVay of K-Mart to Mark Bradlee of WOW, ER 518 Ex. 97 . . . . . App. 343

Letter from Howard Moore of Toys R Us to Don Kingsborough, dated July 15, 1987, ER 518 Ex. 99 . . . . . App. 344

Mattel Toys memo, Subject: Lazer Tag Europe, date: June 24, 1987, ER 518 Ex. 100 . . . . . App. 346

WOW Interoffice Memo from Ross Heil to Don Kingsborough and Bob Goldberg, ER 518 Ex. 98 . . . . . App. 348

Attachments To The Memorandum . . . . . App. 352

June 30, 1987. Letter from TSC Top Sales Company, Inc. to WOW . . . . . App. 352

WOW Interoffice Memo, July 1, 1987 . . . . . App. 353

Letter from Brennan & Howard to WOW, dated June 19, 1987 ER 519 Ex. 101 . . . . . App. 355

ER 522

DAVID B. GOLD,
A PROFESSIONAL LAW CORPORATION
PAUL F. BENNETT, ESQ.
ALAN R. PLUTZIK, ESQ.
595 Market Street, Suite 2300
San Francisco, California 94105
Telephone: (415) 777-2230

KAUFMAN MALCHMAN KAUFMANN & KIRBY
NADEEM FARUQI, ESQ.
919 Third Avenue
New York, New York 10017

KAUFMAN MALCHMAN KAUFMANN & KIRBY
ERNEST T. KAUFMANN
2049 Century Park East, Suite 1100
Los Angeles, California 90067

Co-Lead Counsel for Plaintiffs

UNITED STATES DISTRICT COURT

NORTHERN DISTRICT OF CALIFORNIA

(Filed Oct. 27, 1992)

IN RE WORLDS OF WONDER SECURITIES LITIGATION	Master File No. C-87-5491 SC *Class Action*
This Document Relates To: ALL ACTIONS.	THE DECLARATION OF ALBERT ROSSI, JR. Date: December 11, 1992 Time: 10:00 a.m. Place: Courtroom of the Honorable Samuel Conti

TABLE OF CONTENTS

I. SUMMARY OF OPINIONS 2

A. False and Misleading Financial Statements 2

B. Deloitte's Audit Failures 4

C. Deloitte's Knowledge and Substantial Assistance in the Preparation and Dissemination of the False and Misleading Financial Statements 5

D. Response To May Declaration 5

II. OPINIONS REGARDING WOW'S FISCAL YEAR 1987 FINANCIAL STATEMENTS 5

A. Introduction: Wow's December 10th Dating Program 5

B. The K-Mart Transaction 7

(1) Terms of the K-Mart Transaction .. 8

(2) Under GAAP, Revenue Should Not Have Been Recognized on the K-Mart Transaction 10

(a) Revenue Should Not Have Been Recognized on the K-Mart Transaction Because That Transaction Fails to Meet GAAP's Revenue Recognition Requirements for Sales with a Right of Return 11

(i) Revenue Recognition Standards Under GAAP 11

(ii) Revenue Recognition Was Prohibited by FASB 48..... 13

(b) Revenue Recognition Was Improper Under GAAP Because the K-Mart Transaction Failed to Satisfy the Conditions Imposed by the SEC for the Recognition of Revenue on "Bill and Hold" Transactions 14

(i) SEC Authority Regarding "Bill and Hold" Transactions..... 14

(ii) SEC "Bill and Hold" Authority Prohibits Revenue Recognition With Respect to the K-Mart Transaction.... 15

(iii) The Transaction Was Not Consummated As of March 28, 1987 or Fiscal Year End 19

(iv) Revenue Recognition Was Improper Due To The Provisions Of Blanket Order No. 3 That Allowed K-Mart To Change Quantities Or Cancel The Order 22

(v) Revenue Recognition was Inappropriate for the K-Mart Transaction Because It Appears Much of the Product In Question Was "Shipped" After Fiscal Year-End 22

(vi) The Subsequent History of the K-Mart Transaction Supports the Denial of Revenue Recognition 23

(3) Deloitte's Audit of the K-Mart Transaction Failed to Meet the Standards of GAAS 24

C. Other FOB and Transfer Sales 29

1. Introduction 29

2. Revenue Recognition was improper under GAAP and SEC Authority ... 30

3. Wal-Mart Transactions..... 30

(a) Terms of the Wal-Mart Transactions 31

(b) Under GAAP, Revenue Should Not Have Been Recognized on the Wal-Mart Transaction..... 31

(c) Deloitte's Audit of the Wal-Mart Transactions Failed to Meet of Standards of GAAS..... 33

(d) Gold Circle Transactions..... 35

D. Barter Transactions 37

1. Under GAAP, Revenue Should Not Have Been Recognized on the Barter Transaction 37

(1) Revenue Should Not Have Been Recognized on the Barter Transaction Because The Transactions Fail to Meet GAAP's Requirements for a Completed Transaction 38

(a) Revenue Recognition Standards Under GAAP 38

(b) The Transactions Involved Contingent Future Media Time 38

(c) The Revenue Recorded on the Barter Transactions Was Overstated 40

(d) The Subsequent History of the Barter Transactions 41

(2) Deloitte's Audit Procedures in Connection with the Barter Transactions Failed to Meet the Standards of GAAS 41

E. PRICE PROTECTION, SALES RETURNS & INVENTORY RESERVES 42

1. Price Protection 44

a. Introduction 44

b. Under GAAP and the SEC Regulations, Price Protection Should Have Been Disclosed 44

c. Deloitte's Audit Procedures with Respect to Price Protection Were Nonexistent 47

2. Sales Returns and Allowances 48

a. Introduction 48

b. GAAP Requires that a Reasonable Allowance be Recorded at the Time a Sale With a Right of Return is Recognized or if no Reasonable Allowance can be Made, No Revenue Should Be Recognized 50

c. Deloitte's Audit was not in compliance with GAAS 53

3. Reserves for Inventory were Inadequate 54

a. Introduction 54

b. Inventory Writedowns Under GAAP 55

(1) Inventory Standards Under GAAP 55

(2) Inventory Writedowns Were Required Under GAAP Because WOW Had Significant Excess Inventory at March 31, 1987 55

c. Deloitte's Audit of Inventory Reserves was At Best Cursory .. 57

F. Failure to Disclose Significant Fourth Quarter Adjustments 58

1. Introduction 58

2. Applicable GAAP 58

3. Deloitte's Audit Procedures Fell Far Short of GAAS 59

G. FAILURE TO DISCLOSE EFFECT ON FUTURE REVENUE AS A RESULT OF DATING PROGRAM 60

1. WOW's Dating Program Significantly Affected Fiscal 1988 Sales ... 60

2. GAAP Requires Disclosure of Effect of Dating Program 60

3. Deloitte's Failure to Comply with GAAS 61

III OPINIONS REGARDING WOW'S DECEMBER 31, 1986 FINANCIAL STATEMENTS... 62

A. WOW's December FOB Program..... 62

1. Terms of the December FOB Transactions 62

2. Under GAAP, Revenue Should not Have Been Recognized on the December 1986 FOB Transactions... 63

3. Deloitte's Role in the December 1986 FOB Program..... 64

B. Consignment Sales at December 31, 1986..... 65

C. WOW's Improper Sales Cut Off at December 31, 1986 66

IV OPINIONS REGARDING WOW'S MARCH 31, 1986 FINANCIAL STATEMENTS..... 66

A. Introduction 66

B. Deloitte's Audit Procedures Failed to Comply with GAAS..... 67

V INTERNAL ACCOUNTING CONTROL 68

A. Introduction..... 68

B. WOW's Weaknesses in Internal Control at March 31, 1986..... 69

1. Deloitte's 1986 Management Letter .. 69

C. WOW's Weaknesses in Internal Control at March 31, 1987 70

D. Deloitte's failure to comply with GAAS... 71

VI WOW WAS NOT A GOING CONCERN AT MARCH 31, 1987 72

A. Introduction 72

B. Deloitte's Audit Opinion of WOW at March 31, 1987 Failed to Comply With GAAS 73

1. Inventory Overstock and Sales Plummet 73

2. Cash Burn 74

3. Returns, Allowances and Price Protection 74

VII INDEPENDENCE 76

A. Introduction 76

VIII OTHER 78

A. June 30, 1986 Financial Statements Of WOW Were False And Misleading 78

B. Deloitte Violated Its Responsibility With Respect To Subsequent Events Up To The Effective Date Of The June 4, 1987 Prospectus 79

XIV CONCLUSION 80

I, ALBERT ROSSI, JR. C.P.A., DECLARE AND STATE:

1. I am a Certified Public Accountant, licensed to practice in the State of California. I make this declaration in opposition to Defendants' Motions for Summary Judgment or Summary Adjudication of Claims. I have been retained by plaintiffs' counsel in this matter as an expert witness and consultant regarding accounting, auditing, and financial statement disclosure issues. I have over sixteen years of experience as an accountant and auditor for both publicly held and privately held business organizations. I have served as an accounting and auditing expert, investigative accountant and/or litigation consultant in the area of accounting and auditing in over 60 lawsuits, including more than 50 securities fraud class actions. Additional qualifications are set forth on my resume, which is attached hereto as Exhibit A. My opinions expressed herein are based on my background and experience and on my personal review of the materials specified. If called upon as a witness, I could and would testify competently thereto.

2. I have reviewed the documents submitted by defendant Deloitte & Touche ("Deloitte") in support of its Motion for Summary Judgment. Additionally, I have reviewed the following documents in connection with this engagement:

a. Deloitte's work papers for the following:

(1) Deloitte's audits of the financial statements of Worlds of Wonder, Inc. ("WOW") for the fiscal years ended March 31, 1986 and 1987;

(2) Deloitte's audit of WOW's financial statements as of September 29, 1985;

(3) Deloitte's quarterly reviews for the quarters included in fiscal 1987 and 1988;

(4) Deloitte's engagements in connection with WOW's June 1986 initial public stock offering and June 1987 debenture offering;

b. Deloitte's correspondence files produced in this litigation;

c. the Prospectus for WOW's June, 1986 initial public offering of common stock;

d. the Prospectus for WOW's June 1987, public offering of convertible subordinated debentures;

e. The Third Consolidated Amended Complaint in this action (the "Complaint");

f. WOW's financial statements as filed on forms 10-K and 10-Q for fiscal 1986 and 1987, and for the quarters of fiscal 1988;

g. thousands of documents produced by WOW and third parties in this litigation;

h. the deposition transcripts and exhibits of witnesses Todd A. Wilson, James Tindal, Kerry MacVay, Warren Solt, and William McKee;

i. the transcripts and exhibits of the depositions of Eric Roberts and Ronald Barrington, which I also attended;

j. excerpts from the depositions of Mark Bradlee, Angelo Pezzani, Donald Kingsborough and James Lee Whims; and

k. the declarations of John G. Forsythe and Pat Landversicht.

My firm has spent in excess of 575 hours reviewing and analyzing the above documents, and of that, I have personally spent in excess of 350 hours.

I.

SUMMARY OF OPINIONS

A. False and Misleading Financial Statements

3. The following is an overview of my opinions contained in this declaration regarding WOW's financial statements:

a. WOW's March 31, 1987, financial statements were materially false and misleading and in violation of Generally Accepted Accounting Principles ("GAAP") in that:

(1) Approximately $32 million of revenue was improperly recognized under WOW's March, 1987 FOB Hong Kong and Transfer programs. This includes, without limitation, WOW's large transaction at or near fiscal year-end with K-Mart Corporation (the "K-Mart Transaction").

(2) Approximately $9 million of revenue was improperly recognized under barter transactions

with Admerex International and Deerfield Communications, under which WOW exchanged discontinued products for credits applicable to the future purchase of advertising media time.

(3) At a minimum, the financial statements failed to disclose a contingent liability for price protection on goods recorded as "sales" at March 31, 1987, and the Prospectus failed to disclose the practice of price protection under the business description and MD&A sections.

(4) The financial statements failed to include an adequate provision for sales returns and allowances.

(5) The financial statements failed to include adequate inventory reserves for obsolete, defective, and excess inventories, including inventory valuation reserves.

(6) The financial statements failed to include disclosure of significant fourth quarter adjustments, as required by APB Opinion No. 28.

(7) The financial statements failed to disclose the significant impact on subsequent quarters' revenue resulting from the March 1987 Dating Program.

b. WOW's December 31, 1986, financial statements were materially false and misleading and in violation of GAAP in that:

(1) Approximately $20 million of revenue was improperly recognized under WOW's December, 1986 FOB Hong Kong program.

(2) At least $2.0 million of revenue was improperly recognized on sales of products shipped subsequent to December 31, 1986.

(3) Approximately $2.5 million of revenue was improperly recognized on products consigned to BNS Trade S.A. and Wilson Printing & Premiums, Inc.

c. WOW's March 31, 1986, financial statements were materially false and misleading and in violation of GAAP in that the financial statements failed to include an adequate provision for sales returns and allowances.

B. Deloitte's Audit Failures

4. The following is an overwiew of my opinions contained in this declaration regarding Deloitte's conduct in this case:

a. Deloitte recklessly failed to comply with Generally Accepted Auditing Standards ("GAAS") (AU Section 150) in the conduct of its audit of the March 31, 1987 and 1986 financial statements, including its subsequent events procedures with respect to WOW's June, 1987 public offering of convertible debentures, as is set forth below, in that:

(1) Deloitte failed to maintain in all matters relating to the examination an independence in mental attitude (AU Section 220).

(2) Deloitte failed to exercise due professional care in the performance of its audits and the preparation of its reports (AU Section 230).

(3) Deloitte failed to obtain sufficient competent evidential matter to afford a reasonable basis for its opinions regarding the financial statements (AU Section 330).

(4) Deloitte failed to state in its report that the financial statements did not present fairly the financial position and results of operations of WOW in conformity with GAAP (AU Sections 410 and 411).

(5) Deloitte failed to require that the financial statements contain disclosure of material matters required by GAAP (AU Section 430).

(6) Deloitte failed to adequately plan and supervise the assistants performing the audit work (AU Section 310).

(7) Deloitte failed to qualify its report on WOW's March 31, 1987 financial statements as a result of the uncertainties regarding WOW's ability to continue as a going concern (SAS No. 34).

(8) Deloitte failed to comply with subsequent events procedures with respect to subsequent events from the date of its report up to the effective date of the offering (AU Section 711).

(9) Deloitte's conduct was an extreme departure from the standards of ordinary care for an accountant and auditor. The danger that Deloitte's audit opinion and the financial statements which Deloitte audited would mislead investors was so obvious that in my opinion, Deloitte must have been aware of it.

C. Deloitte's Knowledge and Substantial Assistance in the Preparation and Dissemination of the False and Misleading Financial Statements

5. In my opinion, Deloitte knew of and substantially assisted in the preparation and dissemination of WOW's false and misleading financial statements, and was on notice of facts demonstrating their falsity.

D. Response To May Declaration

6. In a declaration filed with Deloitte's moving papers (the "May Declaration"), Alan May, Jr., C.P.A., has expressed the opinion that Deloitte's audits of financial statements for the fiscal years ended March 31, 1987 and 1986 were in accordance with GAAS, and that certain transactions were accounted for on WOW's financial statements in a manner consistent with GAAP. To the extent and for the reasons set forth more specifically hereinafter, I disagree categorically with those opinions.

II.

OPINIONS REGARDING WOW'S FISCAL YEAR 1987 FINANCIAL STATEMENTS

A. Introduction: Wow's December 10th Dating Program

7. In March, 1987, WOW offered certain of its customers a program under which the customers could purchase products from WOW and not be required to pay for the goods until December 10, 1987. The prospectus for WOW's 1987 debenture offering uses the word "dating" to describe these extended payment terms. WOW's sales

under the "dating" program comprised three types of transactions:

(a) "Transfer Sales". Sales were purportedly made to certain customers under terms which provided that the goods sold would be transfered [sic], not to the customer's premises, but within WOW's warehouses (including public warehouses), and segregated. For goods already in a public warehouse, ownership was purportedly "transferred" to the customer within the public warehouse.

(b) "FOB Sales". Sales were purportedly made to certain customers FOB Hong Kong (hereinafter, "FOB Sales"). Under the FOB program, the customer theoretically assumed ownership of the goods either upon their shipment from Hong Kong to the United States or while they were in transit from Hong Kong to the United States.

(c) "Dated Sales". Sales were made with extended payment terms, with customer payment not due until December 10, 1987. This category included FOB and Transfer Sales, which were made with extended payment terms, and sales where the product was shipped to customer locations from WOW's U.S. warehouses, allegedly as of March 31, 1987.

8. Under the December 10th dating program, WOW recorded sales of approximately $52 million at March 31, 1987 to the following customers:

CUSTOMER	AMOUNT
K mart Corporation	$16,363,686
Zayre Corporation	4,174,465
Toys R Us	2,766,172
Wal-Mart Stores	6,050,438
Gold Circle	190,247
Hills	765,808
Bradlee's	725,638
Child World	559,547
Lionel Leisure	271,946
Other	20,000,000
TOTAL	$51,868,000

9. WOW's sales under its FOB and Transfer Programs were highly material to the Company's fiscal year 1987 financial statements. The $32 million of revenue attributable to these sales represented approximately 10% of WOW's fiscal year 1987 revenues, and produced income before taxes of approximately $12 million , or approximately 42% of WOW's reported pre-tax income for the fiscal year as a whole. In other words, if revenue had not been recognized on these transactions, WOW's reported profit for the 1987 fiscal year would have been flat with the prior year, while revenues in the current year had more than tripled. The importance of these transactions to WOW's *quarterly* financial results was even more pronounced. The FOB and Transfer Sales represented *nearly one-third* of WOW's reported net revenues for the fourth quarter of fiscal 1987 – the quarter immediately prior to WOW's June, 1987 debenture offering. Had the revenue from these transactions not been recorded in the fourth quarter, in place of the fourth-quarter pre-tax profit of approximately $291,000 reported

in the 1987 Prospectus, WOW would have reported a quarterly pre-tax *loss* of *nearly $12 million*.

B. The K-Mart Transaction

10. Among the transactions subject to December 10 "dating" terms was the K-Mart Transaction, in which WOW purportedly "sold" to K-Mart $18.2 million of product pursuant to "Blanket Order No. 3" issued by K-Mart to WOW. Less discounts, allowances and other adjustments, this transaction produced reported net revenues in fiscal year 1987 and the fourth quarter thereof of $16,363,686. The K-Mart Transaction, in and of itself, was material to WOW's fiscal 1987 financial statements. The revenue recorded pursuant to that transaction was 5% of the Company's reported revenues for fiscal 1987 and produced approximately $6 million in pre-tax income. Had revenue not been recognized on the transaction, WOW's reported pre-tax income for fiscal 1987 would have been reduced by more than 20%, and the Company would have reported a fourth-quarter pre-tax loss of some $5.7 million.

11. In my opinion, it was improper under GAAP for WOW to recognize revenue and related earnings in connection with the K-Mart transaction in fiscal year 1987. Indeed, in my view, the question is not even a close one. Moreover, Deloitte's audit work on the K-Mart Transaction fell far short of the level necessary to satisfy GAAS. No reasonable auditor, knowing what Deloitte knew about the K-Mart transaction, would have rendered a "clean" audit opinion on WOW's fiscal 1987 financial

statements. In the sections that follow, I explain the reasons for my opinions.

(1) Terms of the K-Mart Transaction

12. The principal terms of the K-Mart Transaction were set forth in Blanket Order No. 3 and in a letter agreement between WOW and K-Mart bearing the date March 28, 1987 (the "Letter Agreement"). A copy of the K-Mart Letter Agreement and associated documents is attached to the declaration of Alan R. Plutzik, filed herewith, as Exhibit 50. Exhibits to the Plutzik Declaration are hereinafter referred to in the form, "Exhibit ___."

(a) Timing of Order

13. The Letter Agreement stated that Blanket Order No. 3 "will be issued to Worlds of Wonder only upon K-Mart's receipt of a signed copy of this letter and the attached Co-op Advertising Authorization and Specifications form." See Exh. 50 at page WOR0107030, first unnumbered paragraph.

(b) Product to be Purchased and Price

14. The Letter Agreement provided that upon the issuance of Blanket Order No. 3, K-Mart would purchase specified amounts of WOW products with an aggregate gross wholesale price of $18.2 million, less a 3% Co-op Advertising Allowance and a special "early buy and product promotion" deduction of $500,000. Exhibit 50 at ¶¶ 1, 4.

(c) "Shipment" to Public Warehouse

15. Under the Letter Agreement, the merchandise "purchased" by K-Mart pursuant to Blanket Order No. 3 would not be shipped immediately to K-Mart. Indeed, K-Mart had no obligation *ever* to take delivery of it. Rather, the merchandise was to be sent to a public warehouse and drawn down by K-Mart on an "as-needed basis". *Id.*, ¶ 1.

(d) Risk of loss

16. WOW was to bear the risk of loss, damage or physical destruction of the product while it was in the public warehouse or in transit to K-Mart.

(e) Distribution Orders and Right of Cancellation

17. To draw down the product, K-Mart could issue "distribution orders" to WOW at any time specifying the "ship to" point (presumably, one of K-Mart's stores or warehouses) to which the merchandise was to be sent and the date by which it must be delivered. WOW was then responsible for shipping the goods, at its own expense, from the public warehouse to the destination specified by K-Mart. If WOW failed to cause the merchandise to be delivered by the deadline date, K-Mart had the right to "cancel the merchandise" covered by that distribution order and need not pay for it. *Id.*

(f) Warehousing Costs

18. Under Paragraph 3 of the Letter Agreement, the costs of warehousing the merchandise were to be paid by K-Mart, up to a maximum of $15,000 per month or $250,000 per year, with any excess paid by *WOW*. *Id.*, ¶ 3. However, the very next paragraph of the Letter Agreement provided that K-Mart could take a corresponding $250,000 deduction against moneys due to WOW "to cover special handling and inventory charges". *Id.* ¶ 4. Therefore, the Letter Agreement provided, in effect, that WOW would pay all of the costs of storing the product until K-Mart wanted it. The Declaration of John G. Forsythe, WOW's former Manager of Credit and Collections, which I have reviewed, confirms that conclusion. According to Mr. Forsythe, the Credit and Collections Department was instructed that whatever amounts K-Mart paid the warehouse were to be immediately deducted from K-Mart's account payable to WOW. Forsythe Declaration at ¶ 42.

(g) "Stock Balancing"

19. The Letter Agreement gave K-Mart a right to "stock balance" – *i.e.*, to return any or all of the product which was in either the public warehouse or K-Mart's own warehouses as of December 31, 1987, in exchange for other WOW products of K-Mart's choosing. The new products were to be selected on or before January 31, 1988, and delivered on or before July 31, *1988 – sixteen months* after the ostensible date of the Letter Agreement. If K-Mart elected to avail itself of its right of "stock

balancing", WOW was required to pay K-Mart's costs of returning the goods K-Mart no longer wanted, *as well as* the costs of sending new goods to K-Mart in exchange for the old. Moreover, if WOW failed to deliver the new goods by the deadline date set by K-Mart, K-Mart could cancel the order to the extent of those goods and K-Mart would not need to pay for either the returned merchandise or the new merchandise for which K-Mart had attempted to exchange it. Letter Agreement, ¶¶ 5, 7.

(h) "Dating"

20. K-Mart was not required to pay for any of the goods until, at the earliest, December 10, 1987. *Id.*, ¶ 6.

(i) K-Mart Reservation of Rights

21. K-Mart reserved the right to change shipping schedules *or quantities* at its discretion. *Id.*, ¶ 10; form of Blanket Order No. 3, attached to Letter Agreement, at p. WOR0107033.

(2) Under GAAP, Revenue Should Not Have Been Recognized on the K-Mart Transaction

22. As noted above, WOW recorded revenue of over $16 million in its fiscal year ended March 31, 1987 from the K-Mart Transaction. In my opinion, the recognition of revenue on the K-Mart transaction in the 1987 fiscal year was forbidden by GAAP. No revenue should have been recognized on this transaction in fiscal 1987. The inclusion of revenue from the K-Mart Transaction in WOW's

fiscal 1987 financial statements rendered those financial statements materially false and misleading. In approving WOW's recognition of revenue in connection with the K-Mart transaction, Deloitte re lessly violated GAAS and substantially assisted WOW in promulgating false financial statements.

(a) Revenue Should Not Have Been Recognized on the K-Mart Transaction Because That Transaction Fails to Meet GAAP's Revenue Recognition Requirements for Sales with a Right of Return

(i) Revenue Recognition Standards Under GAAP

23. The authoritative literature is clear that for an enterprise such as WOW, revenue from sales of products is recognized at the date of sale, "usually interpreted to mean the date of *delivery to customers*" (APB Statement No. 4, paragraph 1[1]) (emphasis added).

---

[1] APB Statement No. 4 provides, in relevant part: "Revenue is conventionally recognized at a specific point in the earning process of a business enterprise, usually when assets are sold or services are rendered. This conventional recognition is the basis of the pervasive measurement principle known as realization. Revenue is generally recognized when both of the following conditions are met: (1) The earning process is complete or virtually complete, and (2) an exchange has taken place. The exchange required by the realization principle determines both the time at which to recognize revenue and the amount of which to record it. ***Revenue from sales of products is recognized under***

24. Revenue recognition is additionally expanded upon in Financial Accounting Standards Board ("FASB") Statement No. 48, "Revenue Recognition When a Right of Return Exists." FASB No. 48 "specifies criteria for recognizing revenue on a sale in which a product may be returned, whether as a matter of contract or as a matter of, *existing practice*, either by the ultimate customer or by a party who resells the product to others."

25. FASB No. 48 was clearly applicable to the K-Mart Transaction because K-Mart had a contractual right to return the merchandise "purchased" pursuant to Blanket Order No. 3. First, the so-called "stock balancing" right extended to K-Mart under Paragraph 5 of the Letter Agreement – the right to exchange any or all of the product purchased under Blanket Order No. 3 for unspecified future WOW products – *was* a right of return.[2] An additional right of return appeared in the

---

this principle at the date of sale, usually interpreted to mean the date of delivery to customers" (emphasis added).

[2] FASB No. 48 states, in relevant part, in defining the term "returns":

> The product may be returned for a refund of the purchase price, for a credit applied to amounts owed for other purchases, or in *exchange* for other products. Exchanges by ultimate customers of one item for another of the *same* kind, quality and price (for example, one color or size for another) are *not* considered returns for purposes of this statement. (emphasis added).

However, this exemption is inapplicable here. K-Mart's stock balancing rights under Blanket Order No. 3 were not limited to the exchange of one item for another of the *same kind, quality and price*. Rather, under Paragraph 5 of the Letter Agreement, K-Mart had the right to exchange *any or all* of the Blanket

provisions of Paragraphs 1 and 5 which gave K-Mart a right to "cancel" merchandise purchased pursuant to Blanket Order No. 3 if WOW failed to meet K-Mart's deadline dates for the shipment of product from the public warehouse to K-Mart's designated "ship to" points. Furthermore, Blanket Order No. 3 gave K-Mart right to change schedules or quantities at any time – a provision which K-Mart itself apparently regarded as a right of return. *See* Excerpts from the Deposition of James Tindal quoted at paragraph 47, infra. Finally, as is discussed more fully below, *all* of WOW's sales were required to be analyzed under FASB No. 48 because, ["as a matter of existing practice,"] WOW allowed its customers to "stock balance" (See Kingsborough deposition at 114). Deposition excerpts referred to herein are attached to the Declaration of Gregory C. Moore, filed herewith the exhibits in alphabetical order by name of deponent). Moreover, as both Deloitte and Mr. May have acknowledged, WOW customarily accepted returns of non-defective product from its customers. Deloitte Memorandum at ¶ I.B.2.d.; May Decl. at ¶ 21. *See* Exhibits 33, 34 and 3 [McKee Dep. Exhs. 3 and 4 and Audit Planning Memo at 27], Deloitte workpapers which acknowledge WOW's practice of "good product returns". *See also* Landversicht Declaration at ¶ 6; Forsythe Declaration at ¶¶ 5-9, 14-22, 27-29.

Order No. 3 merchandise in its warehouse or the public warehouse at December 31, 1987 for *any* other WOW products of its choosing. Thus, K-Mart had the right to exchange Teddy Bears for video games, toy guns for hand puppets. Moreover, K-Mart was not an "ultimate customer" within the meaning of the exemption.

(ii) Revenue Recognition Was Prohibited by FASB 48

26. FASB No. 48 sets forth six conditions, *all* of which must be met before revenue can be recognized on a sale when a right of return exists. These conditions are as follows:

(1) The price between the seller and the buyer is substantially fixed, or determinable.

(2) The seller has received full payment, or the buyer is indebted to the seller and the indebtedness is not contingent on the resale of the merchandise.

(3) Physical destruction, damage, or theft of the merchandise would not change the buyer's obligation to the seller.

(4) The buyer has economic substance and is not a front, straw party, or conduit, existing for the benefit of the seller.

(5) No significant obligations exist for the seller to help the buyer resell the merchandise.

(6) A reasonable estimate can be made of the amount of future returns.

The K-Mart Transaction failed to satisfy Condition No. 3 – the requirement that revenue cannot be recognized unless "physical destruction, damage or theft would not change the buyer's obligation to the seller." Indeed, the K-Mart Letter Agreement *expressly* provided that the risk of loss due to theft, physical destruction or damage to the goods *would not* pass to K-Mart until the goods were delivered

to K-Mart's stores or warehouses. Thus, as long as the Blanket Order No. 3 merchandise remained in the public warehouse, K-Mart did *not* bear the risk of loss due to theft, physical destruction or damage. Even if K-Mart subsequently placed a "distribution order" requesting the delivery of some or all of the goods, the risk of loss would remain with WOW while the goods were in transit to K-Mart.

27. In other words, under the Letter Agreement, if any of the goods which had been purportedly "sold" to K-Mart and were sitting in the public warehouse or were in transit to K-Mart were stolen, destroyed or damaged, *K-Mart was relieved of its obligation to pay for them.* Therefore, Condition No. 3 of FASB No. 48 was *not* satisfied and FASB No. 48 prohibited the recognition of revenue in connection with the K-Mart Transaction.[3]

28. The K-Mart Transaction also failed to meet Condition No. 6 of FASB No. 48 – that "[a] reasonable estimate can be made of future returns." K-Mart's so-called "stock balancing" right was unlimited in scope and encompassed an extremely long period of time. Under the Letter Agreement, K-Mart could exchange any and all WOW products "purchased" pursuant to Blanket Order No. 3 for any other products marketed by WOW as late as July, 1988. K-Mart was not obligated to decide whether to exercise that right, and WOW would not know whether

---

[3] For that reason, the statement in the May Declaration, at ¶ 10, that "there is nothing in the accounting literature that prohibits revenue recognition merely because the seller retains custodial risks" (defined as risk of *physical loss* or *damage* to the goods) is wrong.

or not K-Mart intended to do so, until January, 1988. Moreover, the right of return was not limited to defective products – it encompassed non-defective products as well. It was foreseeable that K-Mart would attempt to exchange whatever WOW merchandise it had been unable to sell its customers by December 31, 1988. However, there was no reliable basis for computing what K-Mart's "sell-through" of these WOW products would be. Therefore, there was no way for WOW or Deloitte to estimate K-Mart's future returns of product pursuant to the Letter Agreement.

(b) Revenue Recognition Was Improper Under GAAP Because the K-Mart Transaction Failed to Satisfy the Conditions Imposed by the SEC for the Recognition of Revenue on "Bill and Hold" Transactions

(i) SEC Authority Regarding "Bill and Hold" Transactions

29. The Securities and Exchange Commission ("SEC") has identified a category of transaction called a "bill and hold transaction" as to which public companies and their auditors are required to exercise special care in determining whether revenue recognition is appropriate. In a case arising out of the financial statements and practices of the toy manufacturer Mattel, Inc., the SEC stated:

> 'Bill-and-hold' generally is a practice whereby a customer agrees to purchase the goods but the seller retains physical possession until the customer requests shipment to designated locations.

In the Matter of Arthur Andersen, & Co., SEC Release No. 17878, 1981 SEC Lexis 1239 at *7 n.1 (1981) (Exhibit 7). In *Arthur Andersen, supra*, the SEC found that revenue had been improperly recognized by Mattel, with the approval of its auditor, Arthur Andersen, through "bill and hold" transactions.

30. Five years after its *Arthur Andersen* opinion, the SEC reiterated its position with respect to "bill-and-hold" transactions. *In the Matter of Stewart Parness*, SEC Release No. 23507, 1986 SEC LEXIS 1051 (1986) (Exhibit 8). In *Parness*, the SEC clearly identified the specific requirements that a "bill and hold" transaction must meet in order for revenue recognition to occur. These are as follows:

> (1) The risks of ownership must have passed to the buyer;
>
> (2) The customer must have made a fixed commitment to purchase the goods, preferably reflected in written documentation;
>
> (3) The buyer, not the seller, must request that the transaction be on a bill and hold basis. The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;
>
> (4) There must be a fixed schedule for delivery of the goods. The date of delivery must be reasonable and must be consistent with the buyer's business purpose (*e.g.*, storage periods are customary in the industry);
>
> (5) The seller must not have retained any specific performance obligations such that the earning process in not complete;

(6) The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders;

(7) The equipment must be complete and ready for shipment.

Parness, supra, 1986 SEC LEXIS 1051 at *27-*30.

(ii) SEC "Bill and Hold" Authority Prohibits Revenue Recognition With Respect to the K-Mart Transaction

31. Under the SEC's "bill and hold" decisions, revenue recognition was improper for the K-Mart Transaction. The K-Mart Transaction was a "bill and hold" transaction in that it was a transaction in which "the customer agrees to purchase the goods but the seller retains physical possession until the customer requests shipment to designated locations." *Arthur Andersen, supra,* 1981 SEC LEXIS 1239 at *7 n.1. The fact that the K-Mart goods were stored in a California public warehouse paid for by WOW rather than in WOW's own warehouse makes no difference to the categorization of the transaction as a "bill and hold". GAAP requires that financial statements reflect the substance of transactions rather than the form (APB Statement No. 4 ¶ 25).

32. Analyzed under the standards set forth by the SEC for "bill and hold" transactions, the K-Mart Transaction fails the test of revenue recognition. The following chart illustrates that conclusion:

Primary Factors Mandated for Consideration by the SEC	The K-Mart Transaction.
a. The risks of ownership must have passed to the buyer.	a. By the explicit language of the Letter Agreement, the risks of theft, physical damage and destruction of the merchandise *did not* pass to K-Mart at the time of the "sale".
b. The customer must have made a fixed commitment to purchase the goods, preferably reflected in written documentation.	b. K-Mart did not make an unequivocal, fixed purchase commitment. The Letter Agreement gave K-Mart extremely liberal rights of "stock balancing"; entitled K-Mart to change the quantities purchased at will; and authorized K-Mart to "cancel" merchandise subject to the order if WOW did not timely perform certain post-"sale" duties.

c. The buyer, not the seller, must request that the transaction be on a "bill and hold" basis. The buyer must have a substantial business purpose for ordering the goods on a "bill and hold" basis.

c. WOW, not K-Mart, proposed the transaction and suggested that it be on a "bill and hold" basis.*[4]

(*Please see footnote[4] below.)

---

[4] A WOW letter dated March 5, 1987, to Jim Tindal of K-Mart Corporation, documented the initial discussions with respect to the March 28, 1987 K-Mart transaction. The letter states: "As we discussed, WOW has a unique opportunity for K-Mart." On March 20, 1987, Mr. Tindal, in a memorandum to Mr. Sculley, of K-Mart Corporation, summarized the transaction as proposed by WOW. This letter was produced by WOW with various correspondence with K-Mart regarding the March 1987 transaction. Mr. Tindal stated that WOW had offered the following with respect to the K-Mart transaction:

"(1) Store goods in a public warehouse at *their expense* to be drawn into our distribution centers as merchandise is needed.

(2) Items that will be carried over into 1988 that remain in the public facility after December 31, Worlds of Wonder will continue to pay the warehouse cost . . . "

The letter also indicated that the merchandise subject to the K-Mart Transaction represented K-Mart's entire projected usage of the enumerated WOW products for 1987. See Exhibit 51.

Additional evidence supports the conclusion that the K-Mart Transaction was proposed by WOW, not K-mart. See pp. 52-54 from Transcript of the Deposition of James Whims; pp. 14-18 of the Deposition of James Tindal.

d. There must be a fixed schedule for the delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose for ordering the goods on a "bill and hold" basis.	d. Not only was there no fixed schedule for delivery, but K-Mart had the right to return any and all goods in its warehouse or the public warehouse at December 31, 1987, and receive other WOW products in return. Moreover, K-Mart had a right to cancel the deal as to some or all of the merchandise on stated conditions.
e. The seller must not have retained any specific performance obligations such that the earnings process is not complete.	e. WOW retained the obligations: ♦ To pay for the storage of the goods in the public warehouse; ♦ To bear the risks of theft, physical destruction or damage for goods in the public warehouse and goods in transit to K-Mart. ♦ To purchase any and all insurance on the goods, and pay the insurance premiums; ♦ To ship the goods to K-Mart's designated "ship to" point, at WOW's expense, by the dates specified by K-Mart; ♦ To pay the costs of K-Mart's return shipments of goods to WOW, in the

	event K-Mart exercised its right of "stock balancing"; ◆ To provide substitute goods if K-Mart exercised its right of "stock balancing", and to pay for the shipment of those goods to K-Mart.
f. The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders.	f. Deloitte investigated to ensure (i) that the goods in the public warehouse were segregated and (ii) that there was sufficient product "on the water" to cover the portion of the K-Mart transaction that was to be shipped to the public warehouse "FOB Hong Kong." However, there is no indication that Deloitte identified *specific* FOB product "on the water" earmarked for the K-Mart transaction.
g. The equipment must be complete and ready for shipment.	g. See f. above.

33. *Parness* states that in order to qualify for revenue recognition, a transaction must meet *all* of the conditions set forth in the left-hand column above. However, in fact, the K-Mart Transaction meets few, if any, of them. Accordingly, revenue should not have been recognized on the K-Mart Transaction.

34. The May Declaration misses the point when it argues that mere characterization of the K-Mart Transaction as a "bill and hold" transaction does not, in and of itself, make revenue recognition improper. It is true that revenue may *sometimes* be recognized on a "bill and hold" transaction. However, this may *only* be done where the transaction meets the tests set forth by the SEC for such transactions in the *Parness* case. *See* ¶ 31, *supra*. Mr. May does not discuss or even refer to those tests. As shown above, when the K-Mart Transaction is analyzed in light of the SEC's standards, it is clear that revenue recognition is inappropriate.

35. Mr. May's professed reliance on the recitation in the K-Mart Letter Agreement that title to the goods passed to K-Mart on March 28, 1987 is insufficient. First, the statement that "title passed" is conclusory. It is not the sort of "competent evidential matter" that an auditor should rely on for a determination as to the substance of the transaction. The SEC in *Parness* prescribed the factors which accountants and auditors should consider in determining whether revenue recognition is appropriate for a "bill and hold" transaction. "Passage of title" is not one of them, for obvious reasons. Anyone can *claim* that "title passed," and there may be no objective way to confirm this legal conclusion. An auditor's job is to make a determination regarding revenue recognition in light of the *evidence*. Here, reliance on the assertion that "title passed" was unjustifiable in view of the substantial terms of the K-Mart transaction which were inconsistent with the conclusion that an exchange had taken place and that the earnings process had been completed – for example, the fact that risk of theft, loss or damage did not pass;

K-Mart's exceedingly liberal rights of "stock balancing", WOW's payment of warehousing expenses and insurance premiums; WOW's continuing responsibility for shipment of the goods to K-Mart pursuant to "distribution orders" and "stock balancing"; K-Mart's right to "cancel the merchandise" if distribution or stock balancing orders were delivered late; and K-Mart's right to change order quantities at any time.

(iii) The Transaction Was Not Consummated As of March 28, 1987 or Fiscal Year End

36. A further reason why revenue should not have been recognized on the K-Mart Transaction is because the transaction had not been consummated by fiscal year-end. The evidence shows that the Letter Agreement was backdated; that the material terms of the transaction were still being negotiated after fiscal year-end; and that drafts of the agreement were still being exchanged and reviewed as late as April 2, 1987 – two days after the end of WOW's fiscal year.

37. First, the K-Mart Letter Agreement makes clear that Blanket Order No. 3 *"will be issued only upon K-Mart's receipt of a signed copy"* of the Letter Agreement and associated documentation. K-Mart did not receive a signed copy of the Letter Agreement until at least April 3, 1987. Even then, K-Mart was dissatisfied with the manner in which the Letter Agreement had been signed and threatened not to go through with the deal unless the Letter Agreement was personally signed by WOW's Chairman and CEO, Donald Kingsborough. Pezzani

depo. at 346, 353, Ex. 52 [Pezzani depo. exh. 38]. There is evidence that Blanket Order No. 3 was not received by WOW's Account Administration Dept. until April 24, 1987. See Exhibit 50.

38. Paragraph 7 of the Letter Agreement itself recited, notwithstanding its purported date of March 28, 1987:

> This letter supersedes all prior communications, either written or verbal, with respect to Blanket Order No. 3, including without limitation *rough drafts dated* March 19, 1987 and *April 2, 1987.* (Emphasis added).

39. Deloitte auditors Eric Roberts, engagement partner, and Ronald Barrington, engagement manager, have testified that despite this language, they did not even attempt to look at the "rough draft dated April 2, 1987" or, indeed, *any* drafts of the K-Mart Letter Agreement. Roberts dep. at 217-18; Barrington dep. at 38:19 - 39:3[5]. Had they done so, they would have determined that the terms of the transaction between WOW and K-Mart had not been agreed to by March 28, 1987.

40. For example, on Friday afternoon, March 27, 1987, K-mart wrote to WOW to confirm the special terms of Blanket Order #3 – namely, that [a]ll products are purchased on a *sale or return* basis . . . "; and that the

---

[5] The evidence shows that Baldev Madahar, WOW's Controller, faxed a copy of that draft to Eric Roberts. See Exhibit 53 [Madahar Exh No. 34]. Nevertheless, Roberts apparently decided not to read it. As Roberts stated in his deposition, "It's generally speaking, not my practice to go look at drafts and drafts and drafts." Roberts dep. at 217-18.

transaction was a "guaranteed sale."[6] Clearly, as of March 27, there were significant terms of the K-mart transaction still unresolved.

41. On March 30, 1987 (two days *after* the terms of the K-mart transaction were supposedly reached and the goods were supposedly "shipped") WOW's Chairman Donald Kingsborough sent E.J. Sculley of K-Mart a counter-proposal, requesting a response by March 31. The proposed draft agreement sent to Sculley by Kingsborough was significantly different from K-Mart's March 27 draft in that it provided for stock balancing, stated that the order was not a "guaranteed sale", provided for title to pass to K-mart on March 28, 1987 and stated that K-Mart would bear the risk of loss and all costs associated with the warehousing of the product.

42. On *April 2, 1987*, K-Mart faxed to Mr. Kingsborough a proposed draft letter agreement dated April 2, 1987, again changing significant terms of the transaction. The April 2, 1987 letter provided that "risk of loss of or damage to the merchandise will be borne by *Seller*" [i.e., WOW] until received by Buyer at its "ship to" points. It added that if "warehousing costs exceed $250,000 or $15,000/month, which ever is greater, Seller will reimburse Buyer the amount of such excess." The

---

[6] A "guaranteed sale" is a sale under which the seller assures the retailer that if the retailer cannot sell the product to his customers, he has a right to return the product for credit and does not need to pay for it. Thus, a "guaranteed sale", as that term is used in the toy industry, is a sale that is not final and unconditional, since the retailer has the right to return the product if he is unable to sell it. Forsythe Decl., ¶ 17.

letter extended the stock balancing delivery date from January 31, 1988 to July 31, 1988, and deducted $500,000.00 from the price to be paid by K-Mart to WOW as consideration for early purchase and promotion. Additionally, the letter stated that Blanket Order No. 3 would be issued to WOW *only* upon K-mart's receipt of a *signed* copy of the letter. How could the final signed Letter Agreement, which has a date of March 28, 1987, have been consummated by the parties, when the draft letter itself was dated April 2, 1987 and the agreement required K-Mart receive a signed copy prior to the issuance of the Blanket Order?

43. Some time subsequent to April 2, 1987, a final Letter Agreement was prepared, issued by K-mart and signed by WOW. Subsequently, Blanket Order No. 3 was issued. As noted, the final agreement stated: "This letter *supersedes* all prior communications, either written or verbal, with respect to Blanket Order No. 3, including without limitation *rough drafts* dated March 19, 1987 and *April 2, 1987*" (emphasis added).

44. As the above-referenced documents demonstrate, many of the significant terms of the purported "March 28, 1987" K-mart transaction were not finalized until sometime after March 31, 1987. Accordingly, the transaction was *not* consummated as of fiscal year-end, and revenue recognition of the transaction in fiscal year 1987 was inappropriate.

45. Mr. May places reliance on a March 28, 1987 agreement for the timing of the transaction when he acknowledges the letter agreement was not finalized until April 1987. Mr. May does not even indicate if he reviewed

the numerous drafts of the agreements, which contain significant changes, including the *April 2, 1987 draft*. Additionally, Mr. May's reliance on the oral confirmation of the K-Mart agreement has no relevance as to the timing since Mr. Roberts apparently did not inquire as to when the transaction was consummated.

(iv) Revenue Recognition Was Improper Due To The Provisions Of Blanket Order No. 3 That Allowed K-Mart To Change Quantities Or Cancel The Order

46. Separate and apart from the above documents, which support that no sale had occurred as of March 31, 1987, the terms of the Blanket Order in and of themselves preclude revenue recognition until the goods are delivered to K-mart at their ship to points. The form of Blanket Order #3 attached to the Letter Agreement, unequivocally states that "shipping schedule and *quantities* may be changed at Buyer's discretion" and that the *order* could be *cancelled* "at Buyer's option if delivery dates not met."

47. Mr. May does not address the provisions of the Blanket Order #3 which allowed shipping schedules and quantities to be changed and had a cancellation provision. These conditions contradict Mr. May's conclusion that the risks and benefits of ownership have passed to K-Mart. Mr. May concludes that the only factor not met in determining whether an exchange had occurred in the K-Mart transaction was "custodial risk." May Decl. 10. Forgetting the fact that this statement completely contradicts FASB No. 48, May's statement clearly ignores the

conditional nature of the Blanket Order. In fact the K-Mart Blanket Order was nothing more than what it was entitled – an order, which could be changed or cancelled, and certainly *not* a transaction under which revenue should have been recognized in accordance with GAAP.

(v) Revenue Recognition was Inappropriate for the K-Mart Transaction Because It Appears Much of the Product In Question Was "Shipped" After Fiscal Year-End

48. The K-Mart Transaction was a combination of a Transfer Sale and FOB Sale. Some of the goods subject to Blanket Order No. 3 were "transferred" to K-Mart within the public warehouse at 950 Yosemite, Milpitas, California. Other product was purportedly shipped to the public warehouse FOB Hong Kong. However, an internal WOW business record appears to show that a substantial portion of the K-Mart merchandise was not even shipped from Hong Kong prior to fiscal year-end. Indeed, Exhibit 54, an August 6, 1987 memorandum from Mary Padilla of the WOW Sales Administration Department to Philip Rosenberg, the WOW National Accounts Manager who dealt with K-Mart, shows that a substantial portion of the K-Mart merchandise was not shipped until May or June, 1987. The senior accountant in charge of the Deloitte audit has acknowledged (McKee dep. at 180-82) that revenue recognition would be improper in fiscal year 1987 for any FOB shipments made after March 31, 1987. Accordingly, revenue should not have been recognized on such shipments in connection with the K-Mart transactions.

(vi) The Subsequent History of the K-Mart Transaction Supports the Denial of Revenue Recognition

49. After the K-Mart Letter Agreement was signed, both K-Mart and WOW treated the transaction as one which was not a final, unequivocal sale. As early as May 6, 1987 – barely a month after the Agreement was purportedly entered into – K-mart informed WOW that it was overstocked on Lazer Tag inventory and would like WOW to "sell off" 100,000 pieces of Lazer Tag covered under Blanket Order #3. See Exhibit 55. On August 31, 1987, Jim Whims of WOW wrote to K-Mart and stated that WOW would authorize the return of 124,996 Lazer Tag game kits worth over $4.5 million, along with other WOW products.

50. The deposition transcript of Mr. James Tindal, a K-mart buyer of dolls and plush toys during 1986, 1987 and 1988, states:

> Worlds of Wonder came to us with an early purchase agreement in 1987 that we would adjust or amend the terms we were currently working under. . . . In any agreement that we write on a blanket purchase there is a little statement right at the top that we reserve the right to adjust those quantities that we see fit, and that was in that one. But we didn't take this to Worlds of Wonder. Worlds of Wonder brought this deal to us. . . . Well, we talked about the amount versus what we had already purchased from Worlds of Wonder. I think ultimately we decided that what we had coming must be subtracted from their December 10th figures to get

> us down to the amount of product we thought we could use for the year. . . . Purchase orders will be sent by the re-buyer for each distribution center on an 'as needed' basis. This is what we told them we thought we would use. But we always reserve the right to change that dependent upon market conditions. It says so right in the contract. . . . If for some reason the product is not as hot or the consumers are not as mad for it as they were 60 days ago and has stopped selling, we always reserve the right to go back and renegotiate what quantities we will eventually end up with.

Tindal dep. at 14:15-17; 15:1-6; 24:18-23; 39:4-10; 39:13-17.

51. On or about June 3, 1987, K-mart met with WOW to revise Blanket Orders #3 and #4. In a memorandum of the meeting, Kerry MacVay of K-Mart referred to "the original Blanket Order #3 which was to be purchased with a sale or return privilege." The document further notes that Blanket Order #3 is to be reduced to $12,379,000, *cancelling 125,000 units of Lazer Tag*.

52. On October 1, 1987, K-Mart submitted a deduction voucher for the return to WOW of $9.9 million of "Good Product Return Stock Balancing, Adjustment Per Terms of Blanket Order No. 3." The document was countersigned by Mark Bradlee of WOW.

53. In conclusion, the K-mart Blanket Order #3, which incorporated the March 28, 1987 letter agreement, was nothing more than an expression of K-Mart's intention to purchase product which, as noted above, was subject to change and/or cancellation. GAAP requires

that the substance, not the form, of a transaction control the accounting for the transaction. *Based upon the above facts and circumstances, there was no basis under GAAP or the SEC guidelines which would allow revenue to be recognized on the K-mart Blanket Order as of March 31, 1987.*

(3) Deloitte's Audit of the K-Mart Transaction Failed to Meet the Standards of GAAS

54. Deloitte's audit of the K-Mart Transaction was reckless, grossly deficient and fell far short of the standards imposed by GAAS. In its audit of this transaction, Deloitte violated the following applicable GAAS principles – Deloitte failed to maintain an independent mental attitude, failed to obtain sufficient competent evidential matter, failed to insist that WOW's financial statements be presented in accordance with GAAP, did not exercise due professional care. Deloitte failed in its duties in the following ways, among others:

(a) It is axiomatic in the auditing field that significant transactions with unusual terms at or near fiscal year-end merit special scrutiny because they present a particular danger of errors and irregularities. Deloitte recognized the K-Mart Transaction as a "high risk" transaction, but failed to treat it with appropriate thoroughness, independence and professional skepticism. Indeed, WOW personnel have testified that Deloitte *approved* the terms of the deal before it was finally entered into. Circumstances, such as, "the completion of unusual transaction at or near year end; . . . the Company does not

correct material weaknesses in internal accounting control that are practicable to correct; . . . the accounting and financial functions appear understaffed, resulting in a constant crisis condition and related loss of controls" (AU Section 327.08 - .10) are all specifically set forth in GAAS as examples "that may lead the auditor to question whether material errors or possible irregularities exist" and "may cause the auditors to be concerned about the possibility that management may have made material misrepresentations or overridden internal control procedures (AU Section 327.10)." Furthermore, "the auditor should be aware of the importance of management's integrity to the effective operation of internal accounting control procedures and should consider whether these are circumstances that might predispose management to misstate financial statements" (AU Section 327.08 - 327.10). All of the above red flags existed at WOW. Moreover, Deloitte had knowledge of all of these circumstances.

(b) Deloitte exhibited a glaring lack of professional skepticism in auditing the K-Mart Transaction given that Deloitte identified the following special audit risk relating to WOW, as set forth in a preliminary audit planning memorandum: "The Company's ability to meet publicly stated revenue and earnings projections appears unlikely. *Management appears willing to undertake unusual and potentially improper methods to maximize sales*" (emphasis added). The memorandum further states: "Second and third quarter cut off problems resulting from tremendous volume of quarter end shipments were noted during our quarterly reviews. Top management views sales and earnings figures as extremely important." The

preliminary audit planning memorandum was produced from WOW's files. The fact that WOW was apparently provided with a copy of this preliminary memorandum for its review is itself an indication of inappropriate conduct by Deloitte, considering the planning document contains *detailed* audit procedures with respect to each audit area. Specifically for the "high risk" area of accounts receivable, it identifies detailed audit procedures, including tests of sales cutoff and confirmation procedures. In my opinion, it was inexcusable and reckless to provide the audit client with a map of the planned audit procedures. An audit is required to be independent of the client. By disclosing to the client planned procedures, all the elements of independence and professional skepticism are removed.

(c) In a memorandum analyzing the K-Mart Transaction, the auditors acknowledged that the transaction incorporated an exchange privilege and that the requirements of FASB No. 48 were analyzed in order to determine if the principle of realization had been met.[7] However, Deloitte's "analysis" made a mockery of the risk of loss provision of FASB No. 48. The auditors ignored the explicit language of the Letter Agreement to the effect that WOW would bear the risk of loss of the goods while in the public warehouse or in transit to K-mart. They chose not to face the fact that upon theft,

---

[7] It appears that while Deloitte considered the criteria set forth in FASB No. 48, Deloitte believed that the requirements of FASB No. 48 did not apply to stock balancing. This is simply incorrect. As set forth previously, the stock balancing right given to K-Mart was unequivocally a right of return covered by FASB no. 48.

destruction or damage to the product, K-Mart *would not* be obligated to pay for it – a consideration fatal to revenue recognition under FASB No. 48. Rather, the auditors held that FASB No. 48's "risk of loss" requirement was satisfied because WOW had purchased insurance on the warehoused product. Therefore, the auditors concluded, *the insurance company* bore the risk of loss. This conclusion was utterly irrelevant. First, the existence of insurance was irrelevant to the determination of whether the earnings process had been completed and equally irrelevant to whether loss of or damage to the product would affect K-Mart's payment obligations – a condition which FASB No. 48 required the auditors to consider. Furthermore, the auditors apparently never even asked to look at the insurance policy in question. Barrington dep. at 84-85; Roberts dep. 296-298.

(d) The auditors determined that the K-Mart Transaction met some characteristics of a "bill and hold" transaction, but never tried to "classify" the transaction as a "bill and hold". Roberts dep. at 234-245. The auditors acknowledged that the only difference between the K-Mart Transaction and a classic "bill and hold" transaction was that the goods, instead of being sent to *WOW's* warehouse after the "sale", had been sent to *a public warehouse paid for by WOW*. Roberts dep. at 234-245; Barrington dep. at 63-66. Yet, the auditors failed to recognize that this distinction was merely a matter of form, not substance. Although Deloitte's engagement partner, Eric Roberts, was aware that there was SEC authority with respect to the proper treatment of "bill and hold" transactions, none of the auditors read that authority. Roberts Dep. at 245-247. Rather, Roberts limited his research to an internal Deloitte memorandum

which predated the publication of the SEC's *Parness* opinion – the opinion which sets out specific requirements for the recognition of revenue on a "bill and hold" transaction. The material Roberts reviewed sets out a different test for revenue recognition than the test mandated by *Parness*. Moreover, the auditors failed to adequately consider any of the factors which are decisive to a determination of whether revenue can be recognized on a "bill and hold" transaction – *e.g.*, which side proposed the transaction; whether K-Mart had a "compelling" business purpose in having the product stored by WOW instead of being shipped; whether the risks of ownership had passed to K-Mart; or whether WOW had continuing obligations after the "sale". In short, Deloitte completely failed to conduct a prudent or reasonable "bill and hold" analysis.

(e) Deloitte failed to perform the elementary investigative work to determine that the transaction had in fact been consummated before fiscal year-end. In the face of unmistakable evidence that there was a "rough draft" of the Letter Agreement dated after fiscal year end, the Deloitte auditors nevertheless unquestioningly accepted management's representation (a management that Deloitte knew was "willing to undertake unusual and potentially improper methods to maximize sales") that all of the "significant" terms of the agreement had been agreed to before fiscal year end, and never asked or even considered which terms were "significant" and which terms were not. Even though WOW's Controller sent Eric Roberts a copy of the April 2 draft Letter Agreement, Roberts either didn't take the obvious step of reading it to test management's representation that all of

the "significant" terms of the K-Mart Transaction had been agreed to prior to March 31, 1987, or read it and ignored it.

(f) Finally, Deloitte's efforts to "confirm" the K-Mart transaction were not calculated to elicit information Deloitte needed to know about the transaction. Eric Roberts had a conference call on April 3, 1987 with WOW President Angelo Pezzani and a person who represented herself to be K-Mart attorney Nancy LaDuke. However,

(i) Roberts had already decided to approve the K-Mart Transaction and had told WOW President Angelo Pezzani that he was satisfied that revenue could be recognized on it *before* he talked with Ms. LaDuke. Pezzani Dep. at 242.

(ii) Roberts did not confirm the *amount* of WOW's receivable from K-Mart at fiscal year end, or that any amount was in fact owing;

(iii) Roberts accepted Ms. LaDuke's assurance that the terms of the K-Mart Transaction were "K-Mart's normal terms for sales such as this with toy companies," without inquiring or even considering whether there were *any* "sales such as this" between K-Mart and other toy companies.

(iv) Roberts never asked Ms. LaDuke any questions designed to illuminate the requirements of FASB No. 48 or SEC "bill and hold" authority.

(v) There is no indication that Roberts sought or obtained any information regarding the date on which the Letter Agreement had been signed

or the date that Blanket Order No. 3 had been issued. Indeed, had he so inquired, he would have learned that an appropriately signed copy of the Letter Agreement *had not* yet been received and that the Blanket Order had not yet been issued.

(vi) The telephone call did not change the written terms of the transaction, under which revenue recognition was inappropriate.

55. In short, Deloitte approached this transaction with a complete lack of independence, judgment and skill, and with an apparent determination to endorse revenue recognition of the transaction regardless of the dictates of GAAP and without performing the investigation required under GAAS. Deloitte's audit work on the K-Mart Transaction was, at a minimum, reckless. Moreover Deloitte apparently approved the terms of the deal before WOW entered into it, thus substantially and knowingly assisting WOW in its preparation and dissemination of false and misleading financial statements.

C. Other FOB and Transfer Sales

1. Introduction

56. In total, including the K-Mart Transaction, WOW recognized revenue of $16.8 million and $15.1 million on dated FOB and Transfer Sales, respectively at March 31, 1987. These transactions were, in essence, "bill and hold" sales, as was previously defined. The transactions involved the "transfer" of WOW's existing inventory at March 1987, from WOW's inventory to inventory

segregated and marked as the customers; and the recording as a sale of merchandise in-transit from suppliers in the Orient to WOW - US.

57. In my opinion, it was improper under GAAP for WOW to recognize revenue in connection with the dated FOB and Transfer Sales. The issue is not even a gray area. Moreover, Deloitte's audit work on the FOB and Transfer sales failed to satisfy GAAS. No reasonable informed auditor, knowing what Deloitte knew about the FOB and Transfer Sales, would have rendered an unqualified opinion on WOW's fiscal 1987 financial statements. Of the $31.9 million of sales under these two programs, the K-Mart transaction comprised $16.4 million. In addition to the reasons set forth in the K-Mart section, the following sections will provide additional reasons for my opinion that revenue recognition was improper.

2. Revenue Recognition was improper under GAAP and SEC Authority

58. The transactions in general failed to meet the following criteria necessary before revenue and earnings could be recognized:

(a) The condition that physical destruction, damage, or theft of the merchandise would not change the buyer's obligation to the seller.

(b) That a reasonable estimate of the amount of future returns and allowances could be determined at March 1987.

(c) The FOB and Transfer Programs were instituted by WOW in order to enhance sales,

and the customers did not have a compelling business purpose to request a bill and hold transaction.

(d) Risk of ownership did not pass to the buyer of the goods.

(e) These programs modified WOW's normal billing and credit terms for these buyers.

The following sections discuss two particular FOB and Transfer Program transactions, in support of my opinions.

3. Wal-Mart Transactions

59. In March, 1987, WOW recorded in excess of $6 million of revenue from purported Transfer Sales and FOB Sales to Wal-Mart Stores, Inc. The Wal-Mart revenue recorded at March 31, 1987, under the FOB and Transfer sales was, in itself, material to WOW's fiscal year and fourth quarter ended March 31, 1987 reported earnings. WOW reported earnings before taxes of approximately $2.0 million on the Wal-Mart Transactions, or approximately 7% of reported fiscal year 1987 earnings before taxes.

60. In my opinion, it was improper under GAAP for WOW to recognize revenue in connection with the Wal-Mart Transactions in fiscal year 1987. Again, if one applies GAAP and the principles of fair presentation, the issue is not even subject to debate. Furthermore, Deloitte's audit work regarding the Wal-Mart Transactions was reckless, since Deloitte reviewed the very documents which preclude revenue recognition at March 31,

1987, and yet passed upon the transactions. In the following paragraphs, I explain the reasons for my opinions.

(a) Terms of the Wal-Mart Transactions

61. To determine the impropriety of recognizing revenue on the Wal-mart FOB and Transfer Sales at March 31, 1987, one need only review the actual purchase orders issued by Wal-mart with respect to these sales – a procedure purportedly performed by Deloitte in conjunction with its audit procedures at March 31, 1987. The actual purchase orders issued by Wal-mart were dated April 1, 1987, with a cancel date of April 13, 1987. Both purchase orders contained the following language: "Wal-mart reserves the right to *change or cancel orders at any time*" (emphasis added). Additionally, one of the purchase orders, for approximately $1.4 million of product, contains the following language: "Sales in transit to U.S.; Seller agrees on behalf of Buyer to obtain and be responsible for payment of all transportation freight, insurance (marine, or risk, and inland) and U.S. customs duty changes for delivery to alternative destination specified on P.O. (including arranging for the independent quality check of the merchandise), with Seller to *retain* security interest in the merchandise until such delivery (emphasis added)." Indeed, this was standard language for purchase orders under WOW's March, 1987 FOB program.

(b) Under GAAP, Revenue Should Not Have Been Recognized on the Wal-Mart Transaction

62. The Wal-Mart Transactions fail to meet the most basic of revenue recognition criteria, as set forth in APB Statement No. 4 and FASB Statement of Concepts No. 5. No exchange had occurred between WOW and Wal-Mart at March 31, 1987. Wal-Mart purchase orders clearly and simply state that "Wal-Mart reserves the right to *change* or *cancel* orders at *anytime*" (emphasis added). The product was *not* accepted by Wal-Mart as of March 31, 1987 and, in fact, had *not* even been delivered to the customer as of that date.

63. Supporting Wal-Mart's right to cancel the above *orders* was the fact that WOW issued credit memos in April 1987 for approximately $900,000 for Wal-Marts refusal to accept these "sales." Additionally, in my review of the bills of lading associated with these Wal-Mart Transactions, I noted that the product was not shipped to Wal-Mart until mid to late April 1987.

64. In addition to the $6.0 million of sales recorded under the FOB and Transfer Sales Programs to Wal-Mart, WOW recorded revenue of $1.8 million on Lazer Tag product with extended payment terms until December 10, 1987. The purchase with respect to the Lazer Tag product contained the same language regarding the cancelable nature of the order, and in fact in April 1987 Wal-Mart refused to accept 10,000 units – approximately $361,000 – of this product, or 20% of the shipment.

65. Supporting the fact that a sale did not occur as of WOW's fiscal year end March 31, 1987, for the above

transactions with Wal-Mart is correspondence from WOW's sales representative for Wal-Mart indicating that a "non-existent" purchase order was created for WOW to record revenue at March 31, 1987. See Exh. 56. Additionally, letters from Tartan Sales Company dated in May 1987 show that WOW was responsible for paying the storage charges of Wal-Mart product at the public warehouse. Exhs. 57 and 58. A letter dated June 11, 1987, from Tartan Sales Company, to WOW, states the following: "At the end of WOW's 1986 [March 31, 1987] fiscal year, we put a tremendous push on orders to Wal-mart. The actual purchase orders were never received until April. In order to meet WOW's deadlines, a non-existent purchase order was given that was to be replaced by the hard copy P.O." Exh. 56.

66. Revenue recognition was improper under GAAP because the Wal-Mart transaction failed to satisfy the conditions imposed by the SEC for the recognition of revenue on "bill and hold" transactions. As noted in my analysis of the K-Mart Transaction, the SEC has set forth specific criteria that must be considered before revenue can be recognized on a "bill and hold" transaction. In substance, the Wal-Mart FOB and Transfer Sales were "bill and hold" transactions. The merchandise was still under the physical control of WOW regardless of its being stored at a public warehouse or in transit to WOW.

67. The following analysis utilizing the standards set forth by the SEC illustrates how the Wal-Mart Transactions failed to meet the test of revenue recognition:

(1) Contrary to having made a fixed commitment to purchase the goods, Wal-Mart issued purchase orders which allowed cancellation at anytime.

(2) Contrary to the requirement that the risks of ownership must have been passed to the buyer, WOW retained a security interest in the goods until delivery to Wal-Mart.

(3) Contrary to the requirement that the seller not retain any specific performance obligations, WOW retained the obligation of paying for the storage of the goods at the public warehouse[8], the obligation of delivery of the goods to customer's ultimate location, and the obligation of insuring the goods until delivery of goods to customer's ultimate destination.

68. In conclusion, the Wal-Mart Transactions were nothing more than purchase orders issued subsequent to WOW's fiscal year ended March 31, 1987, which, as noted above, were subject to change and cancellation. The goods had *not* been shipped to Wal-Mart as of March 31, 1987, *nor* did Wal-Mart have a fixed obligation to purchase the goods at March 31, 1987. There was no basis under GAAP which would allow revenue to be recognized on the Wal-Mart Transactions.

---

[8] Tartan Sales Company documents, sales representative of WOW, dated in April and May 1987 indicate that Western Distribution Center was attempting to bill Wal-Mart for storage charges. As Mike Needleman of Tartan writes to WOW: "Wal-Mart is still receiving bills from this warehouse. They have no intention of paying for the storage of our software. These bills are annoying to their buying staff." Exhs. 57 and 58.

(c) Deloitte's Audit of the Wal-Mart Transactions Failed to Meet of Standards of GAAS

69. Deloitte's audit of the Wal-Mart Transactions was reckless, grossly deficient and fell short of the standards imposed by GAAS. In its examination of these transactions, Deloitte violated the following GAAS principles – Deloitte failed to obtain sufficient competent evidential matter, failed to exercise due professional care, and failed to insist that WOW's financial statements comply with GAAP. Deloitte failed in its audit in the following ways, among others:

(1) Deloitte purportedly looked at the Wal-Mart purchase orders dated April 1, 1987, which were subject to change and cancellation, to verify the propriety of revenue recognition at March 31, 1987. On their face, the purchase orders did not support revenue recognition, and yet Deloitte did not question the recognition, or perform any additional procedures.[9]

---

[9] Ronald Barrington, Deloitte engagement manager, testified: A. With regards to the purchase orders, really, all I can tell you is what I can read here as far as what he did, which is examine the purchase order and extend it and footed it.
Q. So if Wilson saw the following language on the purchase order, language that appears on purchase order No. 0220072048 in the central column, if you saw the following language, "Wal-Mart reserves the right to change or cancel orders at any time," you didn't understand that he would bring that to anyone's attention in connection with the audit; is that correct?
A. I would think he would bring it to somebody's attention for consideration. (Barrington Dep. at 302: 8-20)

(2) Deloitte failed to test if the Wal-Mart Transactions met the criteria for revenue recognition on a "bill and hold" transaction. In fact, there is no evidence that Deloitte even considered the criteria the SEC had set forth for revenue recognition on "bill and hold" transactions.

(3) Deloitte failed to test whether the Wal-Mart Transactions met the criteria set forth in FASB No. 48 for revenue recognition.

(4) Deloitte failed to review for subsequent credit memos issued in April 1987 related to the purported March 1987 transactions.

(5) Deloitte did not test for shipment of the goods to Wal-Mart or their acceptance thereof.

(6) Deloitte failed to request from customers, as a significant part of its FOB and Transfer Program audit procedures, a confirmation of the customers' receivable – the balance owing to WOW as a result of a sale transaction at March 31, 1987. What Deloitte did confirm was the customers' *purchases* from WOW[10]. It is completely and utterly irrelevant to confirm a customer's purchases, when the audit procedure is designed to validate the assertion that a revenue transaction has occurred resulting in a customer receivable. In

---

[10] Ronald Barrington testified as follows:

Q: Worlds of Wonder has not here asked Wal-Mart to confirm the receivable, has it?

A: We've asked him to confirm the purchase.

Q: And not the receivable, right?

A: From a reading of the letter, I would say it's the purchase. (Barrington dep. 277:1-10)

accounting terms of art, a purchase represents only a commitment on the behalf of the customer to order product from WOW. The fact that a customer confirms that they have placed purchase orders with WOW does *not* provide Deloitte with any verification that a sale has occured or that the customer acknowledged the receivable at March 31, 1987.

(d) Gold Circle Transactions

70. Two letters written by WOW's sales representatives to Gold Circle summarize the actions taken by WOW to overstate its revenues and earnings at March 31, 1987. A letter dated January 15, 1988 states:

> [Gold Circle was] asked by us to do many 'favors,' and take most of their yearly purchases in January, February, and March. They sat on this product all year while the retail prices eroded. They were never comfortable with this situation, but they trusted us.

71. Furthermore, on July 19, 1988, Brennan & Howard, Inc. outlines in a letter how WOW had requested Gold Circle to provide favors to WOW and that WOW would not let them "get hurt." In substance, a term utilized by WOW for a consignment sale.

> Basically, prudent buying practices were set aside at Mr. Kingsborough's request for 'favors' to help W.O.W. make their sales plans. To cite only one example, Gold Circle decided to buy three containers under the 'container' program. I submitted the orders. After numerous phone calls from Don Kingsborough and Jim Whims, and assurances *that they would not let Gold Circle*

> *'get hurt,'* the orders were increased to 8 containers. This product was bought based on Gold Circle's confidence in Don and Jim, personally. We found out later that this was more product that most major national accounts, many times bigger than Gold Circle, ever took in. The 5 additional containers are essentially the overstock problem which is creating the current impasse. (emphasis added).

I have reviewed the Declaration of Pat Landversicht of Brennan Howard, which I understand is being filed with the Court herewith. That declaration confirms the accuracy of the January 15 and July 19 letters referred to above.

72. Gold Circle purchased approximately $1.4 million of product under WOW's December 10th Dating Programs. The quantities shipped to Gold Circle – well in excess of their normal requirements – in conjunction with the extended dating terms, created a situation in which WOW could not reasonably estimate returns[11] and/or other concessions, such as price protection, that would have to be issued in the future to help "sell through"

---

[11] FASB No. 48 states:
However, the following factors may impair the ability to make a reasonable estimate:

a. The susceptibility of the product to significant external factors, such as technological obsolescence or changes in demand.
b. Relatively long periods in which a particular product may be returned.
c. Absence of historical experience because of changing circumstances, for example, changes in the selling enterprise's marketing policies or relationships with its customers.

product. Therefore, under GAAP, revenue recognition could not occur at March 31, 1987.

73. In summary, Deloitte failed to document any audit procedures designed to determine whether sales under WOW's FOB and Transfer Programs, other than K-Mart, such as those to Wal-Mart and Gold Circle, met the revenue recognition criteria established in FASB No. 48 and the SEC with respect to "bill and hold" transactions. These transactions were required to be evaluated in terms of the criteria established in FASB No. 48 due to WOW's stated or implicit practice of allowing product to be exchanged for stock balancing, and "good product" returns. As noted previously, in order for revenue recognition to be appropriate under GAAP, a transaction must meet *all* the criteria set forth in FASB No. 48. The fact that WOW retained the risk of physical destruction, damage, or theft of the merchandise, in itself, precluded revenue recognition. The failure to be able to reasonably estimate returns at March 31, 1987 precluded revenue recognition. Deloitte's failure to test these transactions for compliance with FASB No. 48 and the SEC conditions demonstrates its reckless disregard of due professional care and lack of sufficient competent evidential matter to support its opinion.

D. Barter Transactions

74. During March 1987, WOW entered into agreements with two barter brokers – Deerfield Communications Corporation and Admerex International, Inc., whereby WOW transferred product to these brokers in exchange for *future* advertising media credits. As a result

of these transactions, WOW recorded revenue of *$9,054,000* and earnings before income taxes of *$5,668,000,* at March 31, 1987. These two transactions represented *19.6%* of WOW's reported earnings before taxes at March 31, 1987.

1. Under GAAP, Revenue Should Not Have Been Recognized on the Barter Transaction

75. In my opinion the recognition of revenue on these transactions was improper and contrary to GAAP for the following reasons:

a. The advertising credits received in the exchange by WOW were *contingent* and *conditional* upon WOW purchasing future advertising time through the brokers. Both agreements merely provided for *discount credits* on *future* media time purchases; and

b. The utilization of WOW's standard sales price of the *discontinued* product exchanged for the advertising media credits overstated WOW's revenue and earnings on the transactions. The transactions should have been recorded at the estimated realizable value of a cash transaction, involving the sale of the discontinued product, not at the inflated normal sales price of the goods as was done.

(1) Revenue Should Not Have Been Recognized on the Barter Transaction Because The Transactions Fail to Meet GAAP's Requirements for a Completed Transaction

(a) Revenue Recognition Standards Under GAAP

76. FASB No. 5, "Accounting for Contingencies," reiterates Accounting Research Bulletin No. 50 with respect to the accounting for a gain contingency. It states: "Contingencies that might result in gains usually are *not* reflected in the accounts since to do so might be to recognize revenue prior to its realization." Furthermore, a contingency is defined as "an existing condition, situation, or set of circumstances involving *uncertainty* as to a possible gain . . . to an enterprise that will ultimately be resolved when one or more *future* events occur or fail to occur" (emphasis added). FASB Statement of Concepts No. 5 states that two factors are required *before* revenue can be recognized, "(a) being realized or realizable and (b) being earned." It further states: "Revenues and gains are realizable when related *assets received* or held are *readily* convertible to known amounts of cash or claims to cash." Additionally, it requires that, when assets are exchanged, revenues may be recognized provided they have been earned *and* the transaction is *completed*. Recognition of revenue depends on the requirement that the fair values involved can be determined within reasonable limits.

(b) The Transactions Involved Contingent Future Media Time

77. The advertising media credits were only realizable if WOW: (a) purchased through the barter broker the advertising time available through the broker's vendors, (b) paid the cash portion required by Deerfield and Admerex to utilize the credits, and (c) utilized the credits prior to the expiration date of the agreements. The Deerfield agreement required WOW to pay in cash between 50% to 90% of the media goods or services available to WOW, with the balance being paid through utilization of the credits. The credits expired in 36 months. The Admerex agreement contained similar provisions. Neither agreement provided WOW with guaranteed media time in certain geographic regions or time slots.

78. Due to the fact that barter transactions are common to the broadcast industry, the authoritative literature with regards to accounting practices in the industry, FASB No. 63 "Financial Reporting by Broadcasters" contains a specific section on barter transactions. For an accountant or auditor not to review the authoritative literature dealing with barter transactions in the broadcast industry, when one is auditing in a barter transaction involving media advertising time, would be reckless. In reviewing the propriety of the accounting for a financial transaction, it is common, appropriate, prudent and required by GAAS to review the accounting literature for analogous situations.[12] It would be impossible for the authoritative

---

[12] AU Section 411.08 specifically states:

The auditor *should be* familiar with alternative accounting principles that may be applicable to the

literature to cover all situations or transactions encountered in practice.

79. FASB No. 63 states: "Barter revenue shall be reported when commercials are broadcast, *and* merchandise and services received shall be reported when *received* or used" (emphasis added). This requirement is set forth to comply with FASB No. 5, as noted above, in accounting for gain contingencies. An enterprise must have earned the revenue (broadcast the commercial) *and* the revenue must be realized (goods or services received). In applying the same criteria to WOW's barter transactions, WOW earned the revenue (transferred the goods to Deerfield and Admerex), but the revenue was *not* realized (WOW received credits contingent and conditional upon the utilization and payment of future broadcast media time), and therefore revenue recognition was inappropriate. Mr. May's declaration misses the point that the credits were contingent and under GAAP could not be recorded as revenue. Additionally, Mr. May is just plain wrong

---

> transaction or facts under consideration and realize that an accounting principle may have only limited usage but still have general acceptance. On occasion, established accounting principles *may not exist* for recording and presenting a specific event or transaction because of developments such as new legislation or the evolution of a new type of business transaction. In certain instances, it may be possible to account for the event or transaction on the basis of its *substance* by *selecting* an accounting principle that appears appropriate when applied in a manner *similar* to the *application* of an *established* principle to an *analogous* event or transaction. (emphasis added)

regarding the application of GAAP to analogous transactions.

(c) The Revenue Recorded on the Barter Transactions Was Overstated

80. Furthermore, the fair value of the goods exchanged by WOW, clearly should *not* have been their normal sales price. The products were *discontinued* WOW products with poor retail sales. WOW would have had to significantly discount this product to sell it. To value this exchange at the full sales price of the WOW product exchanged defies the most basic business logic and sense. Deloitte's memorandum analyzing the transaction indicates, at a minimum, that the sales value of the product exchanged should be discounted by 15% (the amount of discount WOW would receive if it contracted directly with the networks for advertising time). While I agree with the direct buy media discount, in reality, it would result in an even greater than 15% gross revenue reduction as Deloitte noted. Since in some cases WOW was only receiving a barter discount credit of 20%, and if they could obtain a discount of 15% directly then the advertising credits only provided WOW with approximately an additional 5% discount. Therefore, the advertising credits were at most worth approximately 25% to 50% of their recorded value. This makes common sense – that since WOW was disposing of discontinued product it would only be receiving approximately 50% to 75% of its normal sales value. As noted, GAAP requires that the substance of a transaction be emphasized over the legal form in determining the appropriate accounting treatment.

(d) The Subsequent History of the Barter Transactions

81. Finally, both WOW and Deloitte knew that as of May 1987, WOW had utilized *none* of the advertising credits. In fact, as of September 30, 1987, six months subsequent to the agreements, WOW had utilized only approximately $700,000 of the advertising credits, or only about 7.7%. By December 31, 1987, WOW recorded significant write downs of the credits, due to the fact that they would never be realized.

(2) Deloitte's Audit Procedures in Connection with the Barter Transactions Failed to Meet the Standards of GAAS

82. Deloitte's audit of the Barter Transactions was reckless, grossly deficient and fell far short of the standards imposed by GAAS. In its audit procedures related to this transaction, Deloitte failed to exercise due professional care, failed to obtain sufficient competent evidential matter, failed to insist that WOW's financial statements be presented in accordance with GAAP, and failed to maintain an independent mental attitude. Deloitte failed in its duties in the following ways, among others:

(a) As previously noted, significant transactions with unusual terms at or near fiscal year end merit special scrutiny because they present a higher risk of errors and irregularities. Deloitte recognized the Barter Transactions as "high risk" transactions, but failed to treat them with appropriate thoroughness, professional skepticism and due care.

(b) In a memorandum analyzing the Barter Transactions, the auditors acknowledged that the revenue on the transactions should be discounted by 15%. The memorandum states: "WOW could contract directly with a media broker and receive such time [at a] 15% discount." The auditors ignored this minimum 15% discount when they audited the revenues on the Barter Transactions. The use of a 15% discount, in itself, would have reduced earnings before taxes by $1.35 million. Deloitte misapplied logic when it determined that a 15% media discount equated to only a 15% revenue discount. At noted previously, these advertising credits required WOW to pay a cash portion for the media time up to 80% of the cost of the media time. Therefore, since WOW on its own could receive a 15% discount the credits were only worth an additional 5% discount. Therefore the credits should have been discounted by 25% to 50%. Furthermore, the auditors completely failed to consider the contingent nature of the advertising credits. As previously noted, the advertising credits represented a gain contingency that was *not* realizable unless and until WOW used the credits within a specified time period. Deloitte fails to address the substance of the agreement – the disposal by WOW of discontinued product for the possibility of future media time discounts. There is *no* current realized benefit to WOW at March 31, 1987. The revenue should be recognized as the credits are used, thus WOW should have recorded advertising expense in an amount equal to the barter revenue – the true economic substance of the transaction.

E. PRICE PROTECTION, SALES RETURNS & INVENTORY RESERVES

83. The next three sections will address three interrelated accounting issues – price protection, sales returns and inventory reserves. The accounting and auditing failures related to these will all involve the following factors among others:

(a) The explosive inventory build-up at WOW which occurred from January through June 1987. Without a corresponding "real" (not manipulated) increase in retail demand, which translates to WOW revenue increases, the inventory build-up had disastrous financial consequences. WOW had in excess of $56 million of inventory at March 31, 1987, with another $42 million on firm purchase commitment. This amount of inventory represents, in terms of WOW's sales, approximately $160 million of revenue. These inventory levels at March 31, 1987, were in spite of all of WOW's revenue manipulations. WOW had recorded $32 million of revenue on product, some of which, would not be delivered to the customer until late 1987. WOW had asked its customers for favors to take most of their 1987 requirements for existing product by March 1987. Even after these manipulations WOW still had excessive inventory levels.

(b) WOW had only $18 million of available funds under its line of credit facility at March 31, 1987. Its accounts payable totalled in excess of $56 million at March 31, 1987. Its accounts receivable at March 31, 1987 included at least $52 million of receivables which

were not due until December 1987. WOW's trade creditors were already stretched out in excess of 60 days. WOW was in a severe *cash crisis* at March 31, 1987 which proceeded to get worse. At June 30, 1987, after raising *$80* million from the public on June 4, 1987, WOW had cash of $84,000; WOW had available bank borrowings of only $5 million; WOW's inventory had increased to $94 million; WOW's trade payables were at $47 million, now in excess of 90 days old; and WOW's sales of $23 million were lower than the prior year's comparable quarter. At June 30, 1986, WOW's inventories were $19 million versus the current $94 million. At June 30, 1987, WOW's financial position, after raising $80 million less than 30 days prior, was bleak. Additionally, a substantial amount of WOW's inventory was Lazer Tag products, a product that was experiencing poor consumer demand.

(c) WOW's major customers were overstocked with WOW's existing products and sell through on the products was poor. Indeed, as the declaration of John Forsythe states by February, 1987 I learned that "consumer demand for the Lazer Tag line had declined dramatically", and during February through May 1987 "a substantial number of customers wanted to return excess inventory of Lazer Tag products." Forsythe Decl. at ¶ 25.

(d) What were WOW's alternatives during January through June 1987? WOW had to report impressive revenue and earnings numbers in order to raise additional capital. WOW would have to reduce its prices in order to move its inventory, and WOW would have to accept returns, including stock balancing for slow moving products. These factors are the very factors that caused inventory valuation reserves to be recorded

(lower of cost or market, excessive inventories); price protection credits to be issued, a common industry practice, since WOW would have to reduce its price to stimulate demand; and sales returns to substantially increase. WOW did not have an alternative to carry the inventory until demand increased since WOW was out of cash and out of borrowing capacity. WOW had to reduce its inventory levels to generate cash flow.

(e) As an auditor, Deloitte was required to be aware of these factors. An auditor must demonstrate an awareness for not only the client's business but additionally the industry in which the client operates (AU Section 311). Deloitte was reckless and grossly deficient in not recognizing the above financial conditions at WOW. It was Deloitte's duty to understand the current financial condition of WOW in order to properly perform its audit.

The above conditions dictated the accounting for price protection, sales returns, and inventory reserves which are discussed in the following sections.

1. Price Protection

a. Introduction

84. Price protection is a practice whereby the retailer is granted credits on merchandise in its existing inventory when the manufacturer lowers the sales price of that product. As acknowledged in Deloitte's memorandum and Mr. May's declaration: "It is a common practice

in the toy industry and in other consumer goods industries to grant retailers 'price protection.' " (May Decl. ¶ 23)

b. Under GAAP and the SEC Regulations, Price Protection Should Have Been Disclosed

85. In my opinion, price protection should have been disclosed as follows:

(a) At a minimum, price protection should have been disclosed as a material contingent liability in the financial statements of WOW at March 31, 1987.

(i) FASB No. 5 "Accounting for Contingencies" requires that a loss contingency be disclosed when it is *reasonably possible* that a liability will be incurred resulting in a loss or impairment of an asset, such as accounts receivable. FASB No. 5 defines reasonably possible as: "The chance of the future event or events occurring is more than remote but less than likely." Furthermore, FASB No. 5 requires that if a loss contingency is probable ("the future events are likely to occur") and estimable then "an estimated loss contingency shall be accrued by a charge to income." Specifically relating to the disclosure of a loss contingency, FASB No. 5 states: "disclosure of the contingency shall be made when there is at least a reasonable possibility that a loss or an additional loss may have been incurred. The disclosure shall indicate the nature of the contingency and shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made." Price protection is a liability incurred in connection with the

sale of goods. Mr. May's statement that "price protection is generally treated under GAAP as a 'period cost', or a cost that is accounted for at the time the price protection is actually given, *not* at the time the original sale is made" is misleading and is *not* in conformity with GAAP. If, at the time of sale, it is probable and estimable that price protection will be issued then a charge to income must be made for the price protection. If, at the time of sale it is reasonably possible that price protection will be issued, then the contingency must be disclosed. Additionally, if an enterprise or industry commonly offers price protection and it is more likely than not that price protection will be issued, the accrual and/or disclosure requirements of FASB No. 5 are met. Furthermore, FASB No. 5 requires that all information available before the financial statements are issued be considered in determining whether a loss contingency existed at the financial statement date.

(b) Price Protection should have been disclosed in the textual portion of the June 4, 1987, Prospectus in the business description and in the MD&A sections;

(i) The SEC in regulation S-K, item 101, requires disclosure of "the practices of the registrant and the industry relating to working capital items (e.g. . . . where the registrant provides rights to return merchandise, or where the registrant has provided extended payment terms to customers)." Item 303 requires that Management's Discussion and Analysis of Financial Condition and Results of Operations disclose: "Any known trends or uncertainties that have had or that the registrant reasonably expects will have a material

favorable or unfavorable impact on net sales or revenues or income from continuing operations." Additionally, Item 303 states: "The discussion and analysis shall focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition. This would include descriptions and amounts of (A) *matters that would have an impact on future operations and have not had an impact in the past,* and (B) matters that have had an impact on reported operations and are not expected to have an impact upon future operations" (emphasis added).

86. The following sections show the basis for my opinions regarding disclosure of price protection under GAAP and Regulation S-K.

(a) WOW's major customers had purchased a significant amount of their 1987 inventory requirements of WOW's existing products and yet WOW's inventory level at March 31, 1987 had ballooned to in excess of $56 million from $17.7 million at December 31, 1986. Additionally, WOW had approximately $42 million in purchase commitments outstanding for additional inventory at March 31, 1987. It was extremely probable that WOW would have to discount its prices to move all of this inventory and, therefore, incur price protection credits.

(b) The extended payment and delivery terms granted to customers to "enhance" sales meant that WOW had to project what the market for its products

would be for the 9 month period, through December 1987 until customers' paid.

(c) WOW had extended formal price protection during March 1987 to Gold Circle. A March 23, 1987 letter written by Brennan & Howard, sales representatives of WOW to Gold Circle, states with respect to a March 12th meeting that "Gold Circle will receive complete price protection on all merchandise received from purchase order numbers G667846 and G668549. This will cover any circumstances in which Worlds of Wonder either lowers its dealers cost or raises its dealer discounts."

(d) As early as September 30, 1986, WOW had considered that the likelihood of its issuing price protection was probable and had accrued $587,000 as a price protection reserve. As Deloitte notes in its work papers prepared in conjunction with its second quarter review, "During 2Q87, client established a Price Erosion reserve of $587k charged to other C.O.S. This cost was recorded in anticipation of amounts which will be owed to retailers holding TRX's in inventory after Christmas when WOW drops the retail price of TRX's." Yet, no reserve was recorded at fiscal year-end March 31, 1987 when conditions in the market had significantly deteriorated.

(e) During the second quarter of fiscal year 1988 (September 30, 1987) WOW recorded price protection charges in excess of $13 million. Furthermore, during the third quarter of fiscal 1988, WOW recorded additional price protection reserves of approximately $6 million. A significant amount of these reserves related to

goods shipped to customers under the March 1987 Dating Program.

(f) Mark Bradlee, Executive Vice President of Sales, testified that price protection was a common industry practice and it was in fact provided to retailers who purchased product under the dating program. Mr. Bradlee testified that the price protection extended through the Christmas season of 1987.[13]

c. Deloitte's Audit Procedures with Respect to Price Protection Were Nonexistent

87. Deloitte did not even address the issue of price protection in its audit work papers for its March 31, 1987 examination. Additionally, during its subsequent review procedures, Deloitte failed to consider the effect of price protection on the March 31, 1987 financial statements. Deloitte's recklessness and lack of due care in not performing *any* audit procedures with respect to a common industry practice such as price protection is a strong indication of Deloitte's failure to conduct a GAAS audit.

---

[13] A: Again, price protection falls into the same category of stock balancing. Within the entire trade, you will not be in business as a company if you lower your price and leave the retailers with the higher priced product. So without having it to be stated with the majority of all accounts, it's an industry standard. Some accounts require it in writing . . . but it's an industry standard.
Q: Did the Company, in fact, provide price protection for any of the customers who bought under the extended payment program between the time the goods were shipped and the Christmas season?
A: Yes. Bradlee dep. at p. 202.

88. Deloitte's failure to consider the effect of the practice of price protection on the March 31, 1987 financial statements was an extreme departure from GAAS for the following reasons:

(a) Deloitte knew or should have known that price protection was a common industry practice.

(b) Deloitte had knowledge that WOW had recorded a liability for price protection in prior financial statements.

(c) Deloitte knew that WOW's inventory levels had skyrocketed at March 31, 1987 and had continued to increase through June 1987. Deloitte knew that this inventory increase was in spite of WOW's improper "sales" programs designed to inflate fiscal 1987 sales. Deloitte knew that WOW had approximately $42 million of inventory on firm purchase commitments at March 31, 1987.

(d) Deloitte failed to inquire of any FOB or Transfer sale customers whether price protection terms were included in the terms under which the goods were "sold" to them.

(e) Deloitte knew that the K-Mart agreement, Blanket Order #3, specifically provides for price protection

under the stock balancing provision. Mr. May improperly interprets this language as providing K-Mart with risk of market decline. However, in reality, it does just the opposite. The provision requires WOW to provide stock balancing goods to K-Mart at the lower of WOW's existing prices or WOW's prices at March 28, 1987. At a minimum, Deloitte failed to confirm the stock balancing and price protection clauses with K-Mart.

2. Sales Returns and Allowances

a. Introduction

89. A provision/reserve for sales returns and allowances must be established when the sale is recorded. FASB Statement No. 5 requires that any costs or losses that are expected in connection with any returns of product sold be accrued at the time of sale. If an enterprise cannot make a reasonable estimate of sales returns at the time a sale is recognized, FASB Statement No. 48 precludes revenue recognition on the transaction. In my opinion, WOW materially understated its reserves for sales returns at March 31, 1986 and 1987. In the following sections I explain the reasons for my opinion.

90. Contrary to Mr. May's declaration and Deloitte's memorandum, Deloitte was clearly aware that WOW had accepted significant "good product" returns prior to March 31 1987. Deloitte notes in its work papers prepared as a result of its review of the June 30, 1986 financial

statements that: "Beginning the 1Q87, client began accepting 'good products' returns in addition to defective returns. Significant portions of returns recorded in 1987 related to good product." In performing its June 30, 1986 review, Deloitte notes that the pre-tax effect of "good product" returns that should have been reserved for at March 31, 1986 was $761,000, or 5% of reported pre-tax income. This was based upon an estimate that 55% of good product returns received in first quarter 1987 related to sales originating in fiscal year ended March 31, 1986. Total good product returns for June 30, 1986 booked by WOW was approximately $1,844,000 – clearly a significant amount.

91. The deposition of Angelo Pezzani, President and Chief Operating Officer, confirms that WOW accepted good product returns.[14] Additionally, Mark Bradlee testified: "I would say that with every customer we ever did

---

[14] Q: For how long did Worlds of Wonder have a policy of accepting good product return from customers to reduce excess product inventory?
A: Mr. Kaufmann, to the best of my recollection, we never had a specific policy, but this is what happens in the toy industry.
Q: You just do it sometimes?
A: No. What happens is, you have a customer. He orders product; you sell product to him. And he believes at certain points in time he has more inventory than he really needs, so he either starts sending the product back or he withholds payments. And what you have to do is work with the retailer to find out exactly what his problem is and work through it with him. So when you say did we have a policy, no, we didn't have a policy. If a retailer called us and said he had a problem, we didn't ignore him. We tried to work with him.
Q: And working with them included taking it back: correct?
A: When a retailer would call us and said he had excessive inventory, many times we try to work through it with him. We

business with, stock balancing is an industry – assumed practice, that you will help out a customer who has an imbalance in his stock." See also, Forsythe Decl. ¶ 15 ("A substantial number of Worlds of Wonder customers, including many of our largest accounts, were allowed to return non-defective merchandise after a valid shipment.") The authoritative literature states without qualification that the criteria of FASB 48 must *all* be met when a right of return exists, either by contract or as a matter of existing practice by the Company.

92. The following facts support my opinion that FASB No. 48 was applicable to all of WOW's sales transactions:

(a) Good product returns are common in the toy industry, and were common at WOW.

(b) WOW granted return privileges (including stock balancing) to numerous of its major customers, on a formal (K-mart) and informal basis.

(c) WOW had accepted good product returns in the normal course of business.

(d) WOW accepted in excess of $30 million of returns in fiscal year ending March 31, 1988, primarily relating to sales recorded at March 31, 1987.

---

sometimes said, okay, if you're going to return this product, how about taking another product dollar for dollar? We'd try to work with him as best we could. (Pezzani dep. at 97: 3-25, 98: 1-16)

b. GAAP Requires that a Reasonable Allowance be Recorded at the Time a Sale With a Right of Return is Recognized or if no Reasonable Allowance can be Made, No Revenue Should Be Recognized

93. The extended dating given to customers at March 31, 1987, made it critical that WOW provide reasonable estimates of the returns that would result from those sales. As early as May 7, 1987, John Forsythe wrote to Baldev Madahar that: "The single greatest issue severely impacting collections is unsold inventory on retail shelves. The shipping of product in late December and January *loaded* in inventory to the retailers at the time that demand was on the down side. Numerous major accounts are withholding payment until W.O.W. either takes product back or redates invoices" (emphasis added). Forsythe Decl., Exh H.

94. On June 10, 1987, John Forsythe issued another memorandum, which identified significant product return issues at that date:

(a) Toys R Us – $686,000 in open deductions for pricing errors and alleged short shipments.

(b) Service Merchandise – $41,000 credit not on accounts receivable.

(c) Srepco Electronics – large return in March 1987 still not credited.

(d) Child World – large amount of advertising deductions taken, and returns have not been credited yet.

(e) Wal-Mart – large amount of returns not credited. (See also the section in this declaration discussing Wal-Mart, wherein Wal-Mart return credit memo's for April 1987 were, at least, $1.3 million).

95. In an August 27, 1987 inter-office memo to Baldev Madahar, John Forsythe highlighted the reasons for WOW's customers lack of payment. The memo states: "Over 50 percent of the nonpayment problems involve either returns not credited or reconciliations involving returns issues. Considering the fact that months pass before a customer return is processed through the system, I do not anticipate the resolution of these problems in the near future." Exh. 59 WOR0164746-761.

96. The returns associated with the K-Mart transaction of March 1987 amounted to $9.9 million. In October 1987, K-Mart submitted a deduction voucher covering the return of good product and stock balancing. Exh. 60.

97. An internal WOW memorandum from Phil Rosenberg to Jim Whims identifies extremely high defective rates with regard to Teddy Ruxpin and Grubby products by Toys R Us and Target. The memorandum is dated September 4, 1986 and indicates that the defective rate is for the last 30-day period. The following defective rates were indicated:

Target	Defective Rate
TRX	22%
Grubby	16%
Toys R Us	
TRX	27.9%
Grubby	14.2%

98. At March 31, 1987, WOW estimated returns based primarily upon defective returns, and provided a minimal provision for good product returns, at sales value, of approximately $1.2 million. WOW's defective return rate utilized for Teddy Ruxpin in the March 1987 analysis was 14.5%. No provision was recorded at March 1987 for any stock balancing under the K-Mart agreement or any other informal or formal stock balancing arrangements. By May 6, 1987, WOW knew that K-Mart wanted WOW to "sell off" a 100,000 pieces of Lazer Tag product. This alone represents a return sales value in excess of $3.6 million.

99. By May 1987, the market for WOW's product, especially Lazer Tag, was saturated and numerous customers had inventory overstock. WOW and Deloitte had knowledge of the following factors which should have raised concern that the return reserves were materially understated at March 31, 1987.

(a) K-Mart, one of WOW's largest customers, was informing WOW that it would not be taking delivery of at least 100,000 Lazer Tag products. This alone represents a revenue decrease in excess of $3.6 million.

(b) The return rate for Teddy Ruxpin of 14.5% of product was materially understated at March 31, 1987. Deloitte acknowledged that the fiscal 1986 return

rate should have been approximately 20%. At December 1987, WOW's return rate, as calculated by Deloitte, for Teddy Ruxpin since inception of product, was 21%. In determining the amount of reserves necessary to reduce accounts receivable, Deloitte and WOW utilized a defective rate of 14.5% which yields an expected amount of future TRX returns of 90,000 units. This equals a reserve of approximately $3.3 million. In the inventory section of its workpapers, Deloitte determined that expected returns for Teddy Ruxpin would be 122,000 units. This difference represents an understatement of the receivable reserve by approximately $1.5 million. Additionally, Deloitte's expected return rate was understated since it utilized a 11% defective rate for version D bears, versus defective rates of 22% and 20%, for versions A and B, and C, respectively.

(c) On July 15, 1987, Toys R Us in a letter to Kingsborough, "reiterate[s] the ongoing problems that we are both facing on our inventory" and identifies overstock items. Toys R Us states it had *193,000* units of Lazer Tag on hand and only sold *919* units during the past week. The letter further states "The Snoopy and Mother Goose tapes are a major problem that will not go away. The Lazer Tag accessories seem hopeless." Exh. 142.

c. Deloitte's Audit was not in compliance with GAAS

100. Deloitte's audit procedures regarding sales returns and allowances were reckless and violated GAAS. Deloitte violated the following applicable GAAS –

Deloitte failed to maintain an independent mental attitude, failed to exercise due professional care, failed to obtain sufficient competent evidential matter to support its opinion, and failed to insist that WOW present its financial statements in accordance with GAAP. Deloitte failed in the performance of its duties in the following ways, among others:

(a) While identifying the area of return reserves as a "high risk" area, Deloitte failed to treat it with appropriate thoroughness, independence and professional skepticism. Deloitte, although aware of the stock balancing provision of K-Mart's Blanket Order No. 3, made no effort to perform any procedures or record a reserve as a result of the stock balancing granted to customers. As a result of stock balancing, K-Mart would return in excess of $9 million of product in October 1987.

(b) As noted throughout this declaration, the inventory build-up of WOW, the overstock positions of customers, the acceptance by WOW of good product returns, stock balancing rights, and high defective rates on the Teddy Ruxpin product created an environment wherein Deloitte should have been conservative in auditing return reserves. Instead, Deloitte failed to insist WOW record reserves for stock balancing, and Deloitte again accepted managements unverified representations as to low defective rates.

3. Reserves for Inventory were Inadequate

a. Introduction

101. At March 31, 1987, WOW had recorded reserves for excess, obsolete, and scrap inventory and lower of cost or market reserves of $1.2 million, or approximately 2% of its total inventory value. However, Deloitte should have been aware that, as noted in the chart below, WOW's inventory had dramatically increased, sales had peaked, and, as noted throughout this declaration the market was saturated with product. This situation subsequently, resulted in WOW recording huge inventory writedowns during the next 9 months.

102. WOW's inventory showed the following inventory and sales increases (including the dated sales programs which had absorbed a significant portion of 1987's demand for existing product):

		Inventory (000's)	Quarterly (000's) sales
December 31, 1986		$ 17,689	$ 132,771
March 31, 1987		$ 56,347	$ 109,458
June 30, 1987		$ 94,453	$ 22,953
September 30, 1987	$ 128,481*	$ 49,705	
December 31, 1987	$ 82,588**	$ 37,058	

*Net of inventory reserves of $10,255,000.

**Net of inventory reserves of $50,072,000.

103. In my opinion, it was improper under GAAP for WOW to *not* record additional inventory reserves for

excess, scrap and obsolete inventory and lower of cost or market writedowns at March 31, 1987. Additionally, Deloitte's audit work on WOW's inventory reserves fell far short of GAAS. In the section that follows, I explain the reasons for my opinion.

b. Inventory Writedowns Under GAAP

(1) Inventory Standards Under GAAP

104. The authoritative literature on inventory reserves is ARB No. 43, Chapter 4. ARB No. 43 states: "A departure from the cost basis of pricing the inventory is required when the utility of the goods is no longer as great as its cost. Where there is evidence that the utility of goods, in their disposal in the ordinary course of business, will be less than cost, whether due to physical deterioration, obsolescence, changes in price levels, or other causes, the difference should be recognized as a loss of the current period." It further states that the loss recorded on inventory under this principle should be at a level designated as "market" for the goods. "Market should not exceed the net realizable value (i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal)." GAAP also addresses losses on firm purchase commitments for goods for inventory, such as those entered into by WOW. ARB No. 43 states: "Accrued net losses on firm purchase commitments for goods for inventory, measured in the same way as are inventory, measured in the same way as are inventory losses, should, if material, be recognized in the accounts and the amounts there of separately disclosed in the income statement. The recognition in a

current period of losses arising from the decline in the utility of cost expenditures is equally applicable to similar losses which are expected to arise from firm, uncancelable, and unhedged commitments for the future purchase of inventory items."

(2) Inventory Writedowns Were Required Under GAAP Because WOW Had Significant Excess Inventory at March 31, 1987

105. Inventory levels at WOW had dramatically increased at March 31, 1987 and continued to grow through June 1987. These increases were: (1) in spite of WOW recording as revenue, thus reducing inventory, approximately $52 million in dated sales at March 31, 1987, and (2) a significant decrease in net sales during the quarter ended June 30, 1987 from the prior quarter, and a decrease from the corresponding quarter of the prior year. The following sections explain the reasons for my opinions.

(1) The Declaration of John G. Forsythe identifies the inventory and market conditions WOW was experiencing during early 1987 through June 1987. The demand for Lazer Tag, one of WOW's major products, had declined dramatically and customers were overstocked.[15]

---

[15] However, by February, 1987, I learned that consumer demand for the Lazer Tag line had declined dramatically beginning immediately after Christmas. The problem persisted and deepened during the months of February, March, April and

(2) As noted throughout this declaration, WOW's major customers had overstocked inventory, especiallywith [sic] respect to Lazer Tag, and the "pipelines were stuffed." The sell through of Lazer Tag and other WOW products was poor.

(3) The condition identified in (b) above, the tremendous inventory build-up of WOW from March to June 1987, and the cash flow constraints of WOW would force WOW to lower its sale price of its inventory.

May, 1987 and, indeed, continued through the time I ultimately left the company in November, 1987. During the months of February, March, April and May, 1987, I understood that it was common knowledge among the WOW sales personnel and manufacturers' representatives with whom I was in constant communication, as well as among many of the Company's customers with whom I spoke, that demand for products in the Lazer Tag line had collapsed and that the level of sell-through at the retail level was terrible. During this time, I understood on the basis of my conversations with the WOW sales personnel and manufacturers' representatives with whom I was in communication that the "pipelines were stuffed" with Lazer Tag kits and accessories, as well as with Teddy Ruxpin books, tapes an [sic] software. I also understood on the basis of my conversations with many of the retailers that I dealt with during the months of March, April and May, 1987 that they were severely overstocked on Lazer Tag kits and accessories and that the products were not moving. This was particularly striking because I was aware that the Company was trying to promote Lazer Tag as an outdoor toy and wa [sic] hoping that it could sell substantial quantities of the product during the Spring and Summer rather than solely during the Christmas season. By May, 1987, I understood, on the basis of my conversations with customers that a substantial number of customers wanted to return excess inventory of Lazer Tag products. Forsythe decl. at ¶25.

WOW did not have the capital to support $90 million of inventory level.

c. Deloitte's Audit of Inventory Reserves was At Best Cursory

106. In my opinion, Deloitte's audit procedures of WOW's excess, obsolete, scrap and lower of cost or market reserves at March 1987 was grossly deficient and fell far short of the standards imposed by GAAS. Deloitte violated the following GAAS – Deloitte failed to exercise due professional care, work was not adequately planned and supervised, sufficient competent evidential matter was not obtained to support Deloitte's opinion, and Deloitte failed to insist that WOW's financial statements be presented in conformity with GAAP. Deloitte failed in its duties in the following ways, among others:

(a) GAAS requires that the auditor "obtain a knowledge of matters that relate to the nature of the entity's business, its organization and its operating characteristics. . . . other matters, such as accounting practices common to the industry, competitive conditions, and, if available, financial trends and ratios should also be considered by the auditor." (AU Section 311.07) Deloitte completely failed to evaluate the reasonableness of the valuation of WOW's ending inventory. Deloitte had or should have had knowledge of all the conditions identified in section (2) above.

(b) Deloitte's analysis of excess inventory was superficial and grossly deficient. Deloitte prepared an analysis of inventory quantities on hand,

inventory intransit, and purchase commitments, by product, at March 31, 1987, and compared that to forecasted sales for products for fiscal 1988. Deloitte performed *no* procedures to review the propriety of management's forecasted sales for fiscal 1988, except to agree the amounts to 1988 budgets. The forecasted sales amounts are the most critical component of the analysis, and again, Deloitte relies solely upon management estimates, without any independent review. Deloitte's lack of procedures regarding inventory valuation when it has extensive knowledge of WOW's inventory levels, cash flow and sales problems is reckless.

F. Failure to Disclose Significant Fourth Quarter Adjustments

1. Introduction

107. At March 31, 1987, WOW capitalized (reclassified from expense to an asset) parts inventory which had been previously expensed throughout the fiscal year. The amount of this adjustment was approximately $2.5 million. Deloitte's work papers state: "Amount represents parts inventory physically held at WOW, Gemini and MPI. Throughout the year WOW expensed its parts inventory. However, in conformity with WOW's prior year policy, per discussion w/Baldev Madahar, Cont., the value of parts on hand were reversed from COGS and capitalized in the parts inventory account."

2. Applicable GAAP

108. The authoritative literature on interim financial reporting, APB Opinion No. 28, states the following regarding significant fourth quarter adjustments:

> "When interim financial data and disclosures are not separately reported for the fourth quarter, securityholders often make inferences about that quarter by subtracting data based on the third quarter interim report from the annual results. In the absence of a separate fourth quarter report or disclosure of the results for that quarter in the annual report, disposal of segments of a business and extraordinary, unusual, or infrequently occurring items recognized in the fourth quarter, *as well as the aggregate effect of year-end adjustments which are material to the results of that quarter should be disclosed in the annual report in a note to the annual financial statements* (emphasis added)."

109. The reported earnings before taxes of WOW for the fourth quarter of 1987 were $288,000. An adjustment to record $2.5 million of earnings as a result of capitalizing previously expensed parts inventory was material to the fourth quarter financial statements and the earnings trend. Without the capitalization of parts inventory WOW would have reported a loss before taxes of approximately $2 million.

110. In my opinion, due to the material amount of the adjustment to record parts inventory on the fourth quarter earnings and the fourth quarter earnings trend, disclosure of the capitalization of parts inventory was

required as a significant fourth quarter adjustment, specified in APB Opinion No. 28.

3. Deloitte's Audit Procedures Fell Far Short of GAAS

111. Deloitte's audit procedures with respect to the capitalization of the parts inventory at March 31, 1987 were superficial at best. The "Audit Summary Memorandum" prepared as a result of Deloitte's audit of WOW for March 31, 1987, states: "In addition, the client capitalized $2700[000] of parts inventory which they had previously expensed throughout 1987." The audit workpapers lack documentation that Deloitte performed any procedures to determine the amount of parts inventory on hand at the prior fiscal quarters – December 31, September 30, and June 30, 1986. This would have been necessary to formulate an opinion as to the immateriality of the fourth quarter adjustment of capitalizing $2.5 million of parts inventory. Additionally, it is unreasonable that WOW would not have had any parts inventory at these prior dates.

112. Furthermore, Deloitte acknowledged in its management letter for fiscal year 1987 that WOW had *"[i]naccurate* monthly financial statements which required *significant* year-end adjustments" (emphasis added). Again, Deloitte assisted WOW in promulgating false and misleading financial statements to present to the public an image of a company with sound accounting systems and accurate financial reporting. Furthermore, Deloitte in its review of the debenture offering affirmatively states that "these adjustments [DH&S audit adjustments] are

significant and *unusual* in nature and will *distort* comparison if not reversed" (emphasis added). Exh. 210. See DTOO2272. Deloitte failed to disclose any fourth quarter adjustments, including the capitalization of parts inventory, and therefore it knew that the fourth quarter financial results were distorted as reported.

G. FAILURE TO DISCLOSE EFFECT ON FUTURE REVENUE AS A RESULT OF DATING PROGRAM

1. WOW's Dating Program Significantly Affected Fiscal 1988 Sales

113. As noted in my earlier discussion of the March 1987 dating program, the program provided extended payment terms to customers until December 10, 1987. In other words, customers would have nine months to sell the goods, including the 1987 Christmas season. Under the terms of many of the dating sales, WOW warehoused goods for the purchasers until they requested that the goods be delivered to their distribution centers or stores, and placed into their retail store inventory. There is no question that the dating program at March 31, 1987 had the effect of "accelerating" revenue into the fiscal year 1987 from fiscal year 1988. If WOW had maintained its normal terms of sale these sales would have been recorded, if at all, in fiscal 1988. Deloitte, as previously discussed, documents this in its workpapers and memoranda.

2. GAAP Requires Disclosure of Effect of Dating Program

APB Statement of No. 4 states:

> In general, information that might affect the conclusions formed by a reasonably informed reader of the financial statements should be disclosed. Disclosure principles carry an implied responsibility to present information so that its significance is apparent to a reasonably informed reader. A mass of detailed information, overly compressed information, and language that may be a barrier to communication are unsatisfactory. Financial statements should inform the reader of matters that may affect his interpretation of them, and may provide additional information that will facilitate his understanding and use of the statements.

114. The March 31, 1987, financial statements of WOW did not contain any disclosure of the dated receivables nor the impact the dating program would have on fiscal 1988 sales. The dating program was significant to WOW's revenue, earnings and financial trends, as noted in this declaration, and as such disclosure of the program and the effects thereof was required under GAAP. FASB Statement of Concepts No. 1 requires that information about an enterprise's performance and earnings should be useful to investors and creditors in assessing the prospects of the enterprise and "representative" (normal recurring activities) of the earning ability of the

enterprise.[16] Additionally, GAAP requires disclosure of the dating terms given on the receivables and the fact that revenue was recognized on goods *not* shipped to customers. WOW's disclosure of recognizing revenue upon shipment contained in the March 31, 1987 financial statements was false and misleading.

3. Deloitte's Failure to Comply with GAAS

115. In my opinion, Deloitte failed to comply with GAAS for the following reasons:

a) The third statement of reporting states:

"Informative disclosures in the financial statements are to be regarded as reasonably adequate unless otherwise stated in the report. The presentation of financial

---

[16] FASB STATEMENT OF CONCEPTS NO. 1 STATES: Investors, creditors, and others often use reported earnings and information about the components of earnings in various ways and for various purposes in assessing their prospects for cash flows from investments in or loans to an enterprise. For example, they may use earnings information to help them (a) evaluate management's performance, (b) estimate "earning power" or other amounts they perceive as "representative" of long term earning ability of an enterprise, (c) predict future earnings, or (d) assess the risk of investing in or lending to an enterprise. They may use the information to confirm, reassure themselves about, or reject or change their own or others' earlier predictions or assessments. Measures of earnings and information about earnings disclosed by financial reporting should, to the extent possible, be useful for those and similar uses and purposes. (FASB Stmnt Concepts)

statements in conformity with GAAP includes adequate disclosure of material matters." (AU Section 431). As noted above, Deloitte failed to require any, much less adequate, disclosure of the dating program in the financial statements.

b) Deloitte failed to exercise due professional care in the performance of its audit and the preparation of the report. (AU Section 230). There is no evidence that Deloitte considered the detrimental effect the dating program would have on fiscal 1988, if revenue was recognized at March 31, 1987.

c) Deloitte failed to obtain sufficient competent evidential matter to support its opinion that the dating program would not detrimentally effect [sic] future years revenues and earnings. (AU Section 326). Deloitte failed to apply any substantive procedures to disclosing the effect of the recognition of revenue on Dated Sales.

III

OPINIONS REGARDING WOW'S DECEMBER 31, 1986 FINANCIAL STATEMENTS

A. WOW's December FOB Program

116. In December 1986, WOW instituted an "FOB Program" whereby customer's orders were recorded as sales upon WOW's product shipping from Hong Kong to WOW USA as opposed to the recording of sales upon product shipment from WOW's U.S. warehouse. WOW, under the FOB Program, agreed and was responsible for the payment of *all* transportation, freight, insurance, and

U.S. custom duty charges and for delivery to the customer's ultimate destination. Additionally, WOW retained a security interest in the merchandise until delivery to the customer. As a result of the FOB Program, WOW recorded sales of approximately $20 million at December 31, 1986.

1. Terms of the December FOB Transactions

117. The terms of the December FOB Program "sales" required that special terms of sale be placed on each order prior to WOW releasing the order. The specific language required for each purchase order was: "Sale in transit to United States: Seller agrees on behalf of Buyer to obtain and be responsible for payment of all transportation, freight, insurance (marine, war risks and inland) and U.S. Customs duty charges for delivery to ultimate destination specified on the purchase order, (including arranging for independent quality check of the merchandise) with Seller to retain security interest in the merchandise until delivery."

2. Under GAAP, Revenue Should not Have Been Recognized on the December 1986 FOB Transactions

118. As noted previously, it was WOW's standard policy, in practice, to allow customers to return non-defective merchandise for credit after shipment. As a result of this practice *all* of WOW's sales had to meet the specified criteria set forth in FASB No. 48 before revenue could be recognized on a transaction. Specifically, WOW's

December 1986 FOB Program did not meet the condition that: "The buyer's obligation to the seller could not be changed in the event of theft or physical destruction or damage to the product." WOW had ongoing obligations to pay and provide insurance on the product, to perform quality control functions, and to bring about transportation of the product to the ultimate customer destination. Additionally, as noted in APB Statement No. 4, GAAP required that the earnings process be complete prior to recognizing revenue on a transaction. The obligations of WOW with respect to the December 1986 FOB transactions constituted significant performance that must be complete prior to revenue recognition. Furthermore, Mr. Barrington testified that the customer did *not* bear the risk of loss with respect to WOW's December FOB sales, as required by GAAP before revenue recognition could occur.[17]

119. As noted in the Declaration of John Forsythe, "it was common knowledge within the Company that the FOB program was a device to generate sales that WOW would not have gotten in that quarter, and that the FOB

---

[17] Q: Did the customer bear the risk of loss or damage to the merchandise under the 12/31/86 FOB sales?
Q: While the goods were in transit?
A: I believe that while the goods were in transit that risk of physical loss had not transferred –
Q: What –
A: – to the buyer.
Q: Sorry.
A: The risk of [physical] loss had not transferred to the buyer.
Q: And also physical damage, correct?
A: Yeah.
(Barrington dep. p 142-3.)

transactions had been entered into in order to pump up WOW's reported sales numbers for the third quarter of fiscal 1987." By accelerating the recording of a sale by approximately 30 days (normal transit time of goods to the U.S., customs clearance, quality clearance and shipment to the customer), WOW stole from fourth quarter fiscal 1987 sales to inflate December 31, 1986 sales' numbers.

3. Deloitte's Role in the December 1986 FOB Program

120. Deloitte was an active participant in the structuring and review of the December 1986 FOB Program instituted by WOW. A November 25, 1986 interoffice memorandum from Eric Roberts and Ronald Barrington documents a meeting held on November 24, 1986, with Baldev Madahar, WOW's controller, to discuss the FOB Program. The memorandum documents that Deloitte was aware of the following: (a) "In order to *enhance* sales and give retailers a priority position in these products, WOW has instituted the FOB Program which works as follows: Buyers wishing initial shipments of these products will issue a purchase order stating that the goods may be shipped FOB Hong Kong for talking toy products. WOW will arrange and pay for the shipment, insurance, customs, warehousing and inspection of these goods until they reach the Buyer's designated *destination*" (emphasis added).

121. It appears that the purpose of the meeting was to determine whether or not Deloitte would pass upon the recognition of revenue at December 1986 on products

sold under the FOB Program. While Deloitte did not perform audit procedures with respect to the December 31, 1986 financial statements of WOW, Deloitte did determine that it was proper to recognize revenue upon shipment from Hong Kong for products sold under the FOB Program. Clearly without Deloitte's approval of the December FOB Program and the recognition of revenue thereon, WOW would not have been able to report the sales under the December 1986 FOB Program at December 31, 1986.

122. Additionally, with respect to the December FOB Program Deloitte states the following: "At the end of the 3Q87, WOW recorded sales of approximately $18 million under its 12/31/86 FOB Program. Because of QA and inspection problems, most of the FOB goods were not received by retailers until mid-late February per discussions with J. Forsythe, credit manager. As a result, through the end of April 1987, WOW still had approximately $8 million unpaid FOB invoices." Exh. 61. This subsequent payment information should have alerted Deloitte to the fact that the customers had *not* accepted ownership upon shipment of the product from the Orient. The customers clearly extended their payment dates based upon *actual* receipt of the goods at their facilities. If the merchandise had been exchanged at December 31, 1986, the actual receipt of merchandise by the customers should have had *no* bearing upon payment terms.

B. Consignment Sales at December 31, 1986

123. At December 31, 1986, WOW had improperly recognized revenue on consignment sale transactions for,

at least, $2.5 million. A consignment sale is a transaction wherein the customer does not have to pay for products purchased until the customer resells the product. Additionally, the customer has full right of return with respect to the product unless resale occurs.

124. GAAP *prohibits* revenue recognition on goods consigned to customers. The issue with respect to the impropriety of revenue recognition on the consignment sales at December 1986 is clear. As documented in a Deloitte interoffice memorandum prepared by Ronald Barrington it states: "On March 3, 1987, Richard Stein, WOW's CFO, informed Eric Roberts that WOW International and WOW-U.S. had improperly recorded revenue because certain sales, in effect, been made on a consignment basis." Exh. 62. In a memorandum dated March 10, 1987, Jeff Wolf, WOW's internal auditor, stated: "I have reviewed certain transactions recorded as sales to BNS Trade S.A. over the period June, 1986 through December 1986. . . . While some of the product appears to have been ordered as stock to support a distributor role for the U.S. military and Europe and the Middle East, at least 1,600k of the related product was, and to a large extent still is, stored at WOW International's expense at Belgium and Hong Kong warehouses. WOW International has shared responsibility for locating subsequent purchasers of the product, and BNS has not been expected to pay for this product until it has collected on the on such subsequent resales." The memorandum further states: "The fact that this product has been shipped and invoiced from both Hong Kong and the U.S. is a *compelling* indication that these shipments were *coordinated* by, or *made* at the *direction* of, *WOW management* in Freemont. . . . It seems

highly unlikely that this individual or others acted unilaterally, or without the knowledge of other corporate level personnel." (emphasis added). Exh. 63.

125. Additionally, when Deloitte was performing its confirmation procedures with respect to February 28, 1987 receivables, it uncovered another consignment sales transaction with Wilson Printing & Premium, Inc. The confirmation was for an invoice in the amount of $525,240. In response to the confirmation, the customer stated: "See our attached purchase order. Merchandise is consigned to Wilsons on condition that all not sold may be returned for full credit as of April 30, 1987." Exh. 5.

C. WOW's Improper Sales Cut Off at December 31, 1986

126. A Deloitte memorandum regarding its review of the quarter ended December 31, 1986 notes that: "There was some $2 million of product recorded as 3rd quarter sales which were actually shipped on the first day of the first quarter." Exh. 64. As noted previously, GAAP requires delivery to the customer prior to revenue recognition. Deloitte failed to require WOW to adjust its financial statements for the improper recognition of these sales.

IV

OPINIONS REGARDING WOW'S MARCH 31, 1986 FINANCIAL STATEMENTS

A. Introduction

127. In my opinion, the March 31, 1986 financial statements of WOW were materially misleading for

failure to accrue adequate reserves for returned goods and inadequately estimating returns and allowances to arrive at a net sales figure. As noted previously, GAAP requires that adequate estimates of returns be recorded when the corresponding sales are recognized. The sales return percentage of WOW's Teddy Ruxpin product was significant throughout fiscal 1986 to fiscal 1988.

128. In the performance of its review procedures on the June 30, 1986 financial statements of WOW Deloitte determined that WOW booked approximately $1,844,000 of good product returns, and, through discussions with Baldev Madahar and Mark Bradlee, estimated that approximately 50%-60% of the returns were for sales recorded in fiscal year ended March 31, 1986. Deloitte estimated the pre-tax effect of said returns was to reduce reported earnings by approximately $761,000. Subsequently, in performing its audit on the March 31, 1987 financial statements of WOW, Deloitte noted that the return rate for fiscal year ended March 31, 1986 should have been approximately 20%. The additional reduction to March 31, 1986 reported earnings, if a return rate of 20% would have been utilized, was approximately $2.0 million. Therefore, WOW, at a minimum, overstated its reported earnings before taxes at March 31, 1986 by approximately $2.8 million, or a 22% overstatement.

B. Deloitte's Audit Procedures Failed to Comply with GAAS

129. Deloitte, at March 31, 1986, again placed undue reliance upon management representations without obtaining sufficient competent evidential matter. Deloitte

in its analysis of returns, at March 31, 1986, determined that WOW had experienced an approximate return percentage of 19.5% on the Nylon model bears. However, Deloitte, based solely upon management representations that the new metal model bears were not experiencing high return rates, determined that a return rate of less than 1% was reasonable. However, as noted in the June 16, 1986 prospectus: "The Company commenced shipments in late December 1985 of a modified version of Teddy Ruxpin intended to correct the problem [Company attributed high rate of returns to failures in built-in cassette player.]" Exh. 65.

130. Since the new model bears had not been shipped from WOW until late December, considering the amount of time it would take for customers to receive the product, stock it into retail store inventory, sell-through to the retail customer, the retail customer return the defective product to the store and the customer return the product to WOW, the defective return rate on the new version would be extremely low. Not enough time would have elapsed to allow the return sequence to occur. Additionally, the quarter from January to March generally has low retail toy sales and therefore a significant amount of the new model toys would still be in store inventories.

131. Deloitte failed to obtain sufficient competent evidential matter to support its work that the return rate on the bears had been reduced from approximately 20% to less than 1%, failed to exercise an independence in mental attitude and failed to exercise informed professional skepticism. Deloitte in its planning memorandum had identified the reserves for returns as a "high risk"

audit area, however, failed to properly conduct its audit procedures in light of such determination.

V

INTERNAL ACCOUNTING CONTROL

A. Introduction

132. As defined in the authoritative literature,

> "Internal control, in the broad sense, includes . . . control which may be characterized as either accounting or administrative as follows:
>
> a. Accounting controls comprise the plan or organization and all methods and procedures that are concerned mainly with, and relate directly to, the safeguarding of assets and the reliability of the financial records. They generally include such controls as the systems of authorization and approval, separation of duties concerned with record keeping and accounting reports from those concerned with operations or asset custody, physical controls over assets, and internal auditing.
>
> b. Administrative controls comprise the plan of organization and all methods and procedures that ate [sic] concerned mainly with operational efficiency and adherence to managerial policies and usually relate only indirectly to the financial records. They generally include such controls as statistical analyses, time and motion studies, performance reports, employee training programs, and quality controls."

133. Deloitte prepared management letters for both March 31, 1986 and 1987 which identified numerous internal control weaknesses. The letters began with a summary regarding WOW as follows:

> "In its two years of existence, Worlds of Wonder, Inc. (the Company) has experienced a phenomenal rate of growth. *This growth, however, has contributed, in part, to a company-wide environment in which the operating disciplines normally associated with a large organization do not exist.* Examples of this lack of discipline include policies and procedures, when established, not being consistently followed; critical deadlines being missed; meetings being cancelled or not starting on time, and unplanned and sometimes excessive staff overtime.
>
> Much of the following letter relates to the accounting and finance function. This function, however, should *not* be singled out within the Company. Rather this letter reflects the fact that (a) we spent the predominance of our time working with accounting and finance, and (b) our expertise is primarily in those areas.
>
> *Accounting and Finance personnel, financial controls, and systems as of the date of our audit report were hardly sufficient to support WOW's existing operations and probably will not be sufficient to support growth. This situation greatly reduces the possibility that the Company will have reliable and timely information for either planning and controlling operations or for reporting financial reports internally or externally.* In order for the Company to correct his [sic] situation, the following areas need to be given immediate executive level

attention as well as the necessary resources" (emphasis added).

B. WOW's Weaknesses in Internal Control at March 31, 1986

1. Deloitte's 1986 Management Letter

134. As clearly noted in Deloitte's management letter to WOW dated May 2, 1986, as a result of the September 28, 1985 audit, "Existing controls and systems are insufficient to support the high rate of growth WOW is projecting. Controls need to be improved to encompass the risks inherent in the large dollar amounts of cash, receivables, and inventory accompanying high growth, as well as to ensure good and consistent internal financial reporting. The current data processing system is inadequate for WOW's continuing needs as it is inflexible and not interactive." The letter further identified weaknesses in accounts payable, accrued liabilities, return reserves, and account reconciliations.

135. On July 10, 1986, Deloitte issued a management letter as a result of its audit of WOW's March 31, 1986 financial statements. This management letter addresses Deloitte's concerns regarding interim financial results stating: "as a result, interim financial results may not always be relied upon." The letter further identified control weaknesses regarding journal entries, product return procedures, point of purchase displays, and legal agreements.

136. In Deloitte's workpapers supporting the management letter, the files indicate that Deloitte prepared 34

"constructive service fact sheets" (Deloitte's internal form for accumulating information to be included in management letters). The forms included the following significant comments:

(a) Accounts receivable detail aging is not being reconciled on a periodic basis.

(b) Regarding journal entries – numerous journal entries lacked supporting documentation, and a series of approximately 35 journal entries was missing.

(c) Estimates of expected product returns were too low and required a material adjustment at fiscal year end.

C. **WOW's Weaknesses in Internal Control at March 31, 1987**

137. On July 31, 1987, Deloitte issued its management letter to WOW as a result of its 1987 audit. The letter acknowledged: "Accounting and Finance personnel, financial controls, and systems as of the date of our audit report were *hardly sufficient* to support WOW's existing operations and probably will not be sufficient to support growth. This situation greatly reduces the possibility that the Company will have *reliable* and *timely* information for either planning and controlling operations or for *reporting financial* results internally or *externally*" (emphasis added). Furthermore, the letter stated with

respect to the accounting and finance function at WOW: *"In summary, the department appeared to lack the discipline, direction, and supervision necessary to provide management with accurate and timely financial data. . . . The above resulted in: Inaccurate monthly financial statements which required significant year-end adjustments"* (emphasis added).

138. Additionally, on September 1, 1987, Deloitte issued to WOW management a letter detailing other items for management's attention. The letter encompassed *19* pages of additional weaknesses in internal controls at WOW. These weaknesses, included, but are not limited to:

a) Lack of adequate documentation supporting March 1987 returns, and reiterates that in fiscal 1987 WOW began receiving good product returns.

b) Interim reconciliations of cash, accounts receivable, inventory, intercompany balances, point-of-purchase displays were not performed on a timely basis and WOW recorded *significant* year-end adjustments as a result of reconciling these accounts.

c) WOW experienced problems with refused shipments, collection delays and consignment sales in accounts receivable.

d) Numerous EDP weaknesses were identified.

139. Previously, in January 1987, Deloitte submitted to WOW a comparison of a "Typical $300 million Public Company" versus WOW. The document highlights the following weaknesses known to Deloitte:

a) "Financial statement problems often do not have priority. Thus, if prioritization is incorrect or time constraints are dramatic, potentially material problems may not be addressed."

b) "Other than CFO, no experienced external reporting function exists. DH&S responsible for preparation of financial report which will change substantially from prior year. In prior two audits fairly long management reports were prepared and maybe required again this year."

D. Deloitte's failure to comply with GAAS

140. GAAS requires an auditor to "communicate to senior management and the board of directors or its audit committee material weaknesses in internal accounting control that come to his attention during an examination of financial statements made in accordance with GAAS." As defined in SAS No. 30, a material weakness is:

> A weakness in internal accounting control is a condition in which the specific control procedures, or the degree of compliance with them, are not sufficient to achieve a specific control objective – that is, errors or irregularities may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. A weakness is material if the condition results in more than a relatively low risk of such errors or irregularities in amounts that would be material in relation to financial statements.

141. In its management letters, as a result of both the audits for fiscal 1986 and 1987, Deloitte acknowledges the very essence and substance of material weaknesses in internal accounting controls. For March 31, 1986, Deloitte states: "Interim financial statements may *not* always be *relied* upon" (emphasis added). For March 31, 1987, Deloitte acknowledges: "[i]n summary, the department appeared to *lack* the discipline, direction, and supervision necessary to provide management with *accurate* and *timely* financial data. . . . The above resulted in: *[i]naccurate* monthly financial statements which required *significant* year-end adjustments" (emphasis added). These types of weaknesses are material weaknesses – they result "in more than a *relatively low* risk of such errors or irregularities in amounts that would be material in relation to financial statements," i.e. make the financial statements unreliable. Again, Deloitte lacks any independence and fails to affirmatively state that WOW had material weaknesses in internal accounting control. Deloitte failed to disclose WOW's weaknesses as material to avoid putting the banks, underwriters and the public on notice of WOW's lack of controls, lack of adequate personnel, and lack of capability to prepare "accurate" and "timely" financial reporting.

142. In my opinion, the above identified weaknesses comprise material weaknesses in the internal accounting controls of WOW. Reasonable auditors based upon these facts and circumstances cannot disagree. Deloitte's failure to identify said weaknesses as material weaknesses was a violation of GAAS.

VI

WOW WAS NOT A GOING CONCERN AT MARCH 31, 1987

A. Introduction

143. GAAS required that the auditor issue a qualified opinion (an "except for" opinion) on an entity's financial statements when information came to the auditor's attention that raised questions as to the entity's ability to continue in business. The applicable GAAS at the time Deloitte performed its audits of WOW was SAS No. 34, "The Auditor's Consideration When a Question Arises About an Entity's Continued Existence." SAS No. 34 requires:

> "In an examination of financial statements in accordance with generally accepted auditing standards, the auditor does not search for evidential matter relating to the entity's continued existence because, in the absence of information to the contrary, an entity's continuation is usually assumed in financial accounting. Nevertheless, the auditor remains aware that auditing procedures applied primarily for other purposes may bring to his attention information contrary to that assumption. In forming an opinion on the financial statements, the auditor considers any such contrary information, together with any factors tending to mitigate that information and any management plans for dealing with the underlying conditions."

B. Deloitte's Audit Opinion of WOW at March 31, 1987 Failed to Comply With GAAS

144. In my opinion, it was improper under GAAS for Deloitte to issue an unqualified opinion of WOW's March 31, 1987 financial statements. Moreover, Deloitte's audit work in supporting its opinion fell far short of the level necessary to satisfy GAAS. In the sections that follow, I explain the reasons for my opinion.

1. Inventory Overstock and Sales Plummet

145. At June 1987, WOW's inventory levels had dramatically increased to in excess of $90 million. Additionally, WOW had outstanding purchase commitments of goods that would be arriving within 60 days. See the discussion in the price protection, sales returns, and inventory reserve sections of this declaration. Deloitte was aware, or should have been aware, of all of these facts.

146. Even with the improper recording of sales in the fourth quarter of fiscal 1987 to inflate its earnings, WOW still had a tremendous inventory build-up. The impact of WOW's sales practices in the fourth quarter of 1987 was to significantly reduce, at least, the sales in WOW's first two quarters of fiscal 1988. Deloitte had knowledge that product was being held for major customers for future deliveries in calendar 1987, under the dating program at March 31, 1987. It must be remembered that the $52 million in *dated* sales had already reduced the inventory amounts reported at March 31, 1987, by approximately *$30* million. WOW's sales had

dried up. WOW reported net revenue of only *$1.3* million for April. In May, WOW's net sales were only *$6.0* million. See the declaration of John G. Forsythe.

147. All the inventory and sales trends, as noted previously, were known to Deloitte. These red flags were indicators of significant negative financial trends occuring at WOW. As Deloitte notes in its first quarter fiscal 1988 review: "WOW-USA sales decreased [approximately] 15% from 1Q87, due to large sales push in the final Q of 1987, which *precluded* 1Q88 sales. Additionally, TRX was less than a year old last year, as opposed to having seen 2 Christmas seasons by this Q. Additionally, much of the World of TRX and the Pleasant Dreams line have been discontinued" (emphasis added).

2. Cash Burn

148. The inventory build-up created a tremendous cash requirement that resulted in WOW, at June 30, 1987, having virtually *no* cash after raising $80 million *less* than one month earlier. As shown in WOW's financial statements for the quarter ended June 30, 1987, WOW's cash used by operations *exceeded $47* million. At June 30, 1987, WOW had only $5 million available in its unused bank line of credit.

149. Additionally, as a result of its dating program, WOW had $52 million in accounts receivable from March 1987 "sales" not due until December 10, 1987. Furthermore, WOW's barter transactions generated no cash flow for WOW.

3. Returns, Allowances and Price Protection

150. Due to slow sales, resulting from WOW's recording as sales in March 1987 as much in future deliveries as possible, and a tremendous build-up of inventory, WOW was faced with giving additional discounts to move its product. As a result, WOW offered a "breadth of line" discount of 14% to "induce sales," in the first quarter of fiscal 1988.

151. Mr. May, in his declaration, acknowledges that an auditor must consider an entity's ability to continue in existence for a 12 month period. WOW filed for bankruptcy on December 21, 1987, *less* than 9 months from WOW's March 31, 1987 financial statements, upon which Deloitte issued an unqualified opinion dated May 14, 1987. The factors leading to the filing of WOW's bankruptcy existed during May and June 1987 as noted throughout this declaration. Contrary to Mr. May's declaration, it is *irrelevant* what WOW's sales were during the fiscal year ended March 31, 1987 (a year in which WOW improperly inflated its sales by, at least $41 million). Additionally, the fast paced growth of WOW during 1986 and 1987 contributed to the conditions of the bankruptcy filing, which included, but was not limited to, material weaknesses in internal control, tremendous inventory build-ups, lack of cash flow, and a management orientation to meet publicly disclosed earnings forecasts in order to raise additional capital.

152. Deloitte's going concern analysis, which comprises, a single workpaper, performed as of March 31, 1987, focuses solely on WOW's operating plan calling for the Company to obtain $200 million in outside financing.

William McKee, the Deloitte auditor who prepared the workpaper, concluded that the $200 million will be achieved by receiving $100 million from the debenture offering and $120 million from a renewal of WOW's bank credit facility. When WOW's debenture offering was reduced to $80 million, Deloitte's auditor Ronald Barrington concluded that the $200 million would still be obtained since WOW would receive $80 million from the offering and $120 million from the credit line. This simplistic calculation failed to address the serious conditions of WOW's financial viability which existed during March through May 1987, and which raised serious doubts about the Company's continued existence. These conditions have been identified throughout this declaration. Additionally, WOW even if it did receive a $120 million credit line, could *not* utilize the full amount of $120 million, without having eligible accounts receivable. The line of credit was *limited* to 75% of "eligible" accounts receivable, which would limit WOW's borrowing ability during fiscal 1988. In fact, at June 3, 1987, 75% of the Company's "eligible" accounts receivable amounted to approximately $80 million.

153. Deloitte's simplistic analysis showed a complete disregard for professional due care. Deloitte did *not* question the attainability of WOW's operating plan; did *not* consider the 75% "eligible" accounts receivable limitation of bank borrowings; did *not* consider the excessive inventory levels at WOW; did *not* consider the cash flow impact of the dating and bartering transactions; did *not* consider the state of the market for WOW's products, especially Lazer Tag; and did *not* consider the poor sales of WOW during April and May 1987.

154. In conclusion, the above information which Deloitte had knowledge of represented significant "contrary" information which directly bore upon WOW's ability to continue as a going concern. How was WOW going to meet future obligations and remain solvent, when even after raising $80 million the Company had virtually no available credit on its bank line of credit? This information was readily obtainable by Deloitte, and should have been considered by Deloitte prior to the June 1987 Debenture Offering. There is no documentation that Deloitte considered these factors in concluding that a going concern qualification was not required at March 31, 1987.

VII

INDEPENDENCE

A. Introduction

155. GAAS requires that: "In all matters relating to the assignment, an independence in mental attitude is to be maintained by the auditor or auditors." Furthermore, "To be independent, the auditor must be intellectually honest; to be recognized as independent, he must be free from any obligation to or interest in the client, its management, or its owners." Interrelated with the Standard of Independence is the concept of "professional skepticism." Statement on Auditing Standards No. 16 requires that: "The auditors should plan and perform his examination with an attitude of professional skepticism, recognizing that the application of his auditing procedures may produce evidential matter indicating the possibility of errors or irregularities. The scope of the auditors examination would be effected by his consideration of internal

accounting control, by the results of a substantive test, and by circumstances that raise questions concerning the integrity of management."

156. Deloitte, as documented previously in this declaration, knew that "The Company's ability to meet publicly stated revenue and earnings projections appears unlikely. Management appears willing to undertake unusual and potential improper methods to maximize sales." Deloitte was on notice prior to commencing their audit procedures with respect to the March 31, 1987 financial statements of WOW that management lacked the basic integrity necessary to place reliance upon management representations. With this increased risk of intentional distortion of the financial statements by management, Deloitte should have questioned whether accounting principles that are otherwise generally accepted, were being used in inappropriate circumstances by WOW to create a distortion of earnings. As opposed to questioning transactions in which revenue recognition was unusual and inappropriate, Deloitte participated in the structuring of those transactions, i.e., K-Mart, Barter Transactions and FOB Program.

157. In my opinion, Deloitte did not exercise an independence in mental attitude, nor the appropriate professional skepticism in the performance of its audits for the March 31, 1987 and 1986 financial statements of WOW. The following section sets forth the additional facts upon which I base this opinion. Additionally, throughout the declaration there are instances noted in which Deloitte failed to properly exercise the appropriate independence in mental attitude and professional skepticism required of an auditor under GAAS.

a. On November 5, 1986 in a letter written from the engagement partner, Eric Roberts to Donald Kingsborough, Mr. Roberts states the following: "We were, therefore, happy to provide substantial fee discounts because they represented our 'investment' in WOW. However, these arrangements allowed us to be 'made whole' when you went public." Furthermore, Roberts acknowledges Deloitte's improper billing of its fees in order to benefit the earnings of WOW. The letter states: "The $141,400 of charges relating to the IPO includes not only 'normal' IPO work, but also work related to (a) our special report (as requested by the underwriters) on the design of your EDP systems and the related internal controls, and (b) services related to your aborted private placement, charges for these two items approximated $28,000. ***We agreed to bill these services as part of the IPO because IPO fees are deducted from capital raised (capital stock) and are not, therefore, expensed on your financial statements***" (emphasis added).

b. On October 21, 1986, Deloitte in an inter-office memorandum from Eric Roberts identifies significant conflicts between Mr. Stein, CFO of WOW, and Angelo Pezzani and Donald Kingsborough. The memorandum states that Stein had the opinion that Deloitte should be fired and that Deloitte was incompetent. The memorandum indicates that Deloitte was very concerned with losing WOW as a client during this time period.

c. Additionally, in the November 5, 1986 letter to Kingsborough, Roberts highlights the importance of WOW as a client to Deloitte: "You are one of our most prized clients and it is very important that you and your

people remain happy with DH&S and the services we render."

158. In conclusion, as noted above an throughout this declaration Deloitte failed to maintain an independent mental attitude, with appropriate professional skepticism.

159. Throughout the performance of its March 31, 1986 and 1987 audits, WOW continually placed undue reliance on management representations when the true substance of transactions – K-Mart, Barter Transactions, Wal-Mart, going – concern, sales returns and allowances, dating program, FOB program, among others, indicated a different accounting treatment then that proposed by WOW. Deloitte placed reliance on management it knew was "willing to undertake unusual and potentially improper methods to maximize sales." Deloitte even compromised its independence by improperly billing its own fees to boost WOW's earnings. Deloitte documents in its own correspondence with WOW that it is making an "investment" in WOW and was primarily concerned with WOW remaining happy with Deloitte.

VIII

OTHER

A. June 30, 1986 Financial Statements Of WOW Were False And Misleading

160. In my opinion, based upon the declaration of John Forsythe, the June 30, 1986 financial statements of WOW were false and misleading for improperly recognizing revenue on consigned or "guaranteed" sales. The

declaration of Mr. Forsythe establishes that WOW recognized "guaranteed sales" as revenue in an amount of approximately $2.7 million at June 30, 1986. Additionally, as previously noted, WOW improperly recognized consigned shipments to BNS as revenue at June 30, 1986, in an amount of approximately $1.0 million. The effect of this improper revenue recognition was to *understate* the loss before taxes by approximately $1.4 million, or approximately 42%.

161. Furthermore, in the First Quarter Report to Shareholders, Mr. Kingsborough states: "Another factor affecting our earnings in the first quarter was the seasonal nature of the toy business. Rather than fighting that seasonality, WOW takes advantage of it. A majority of retail toy sales occur in the four months prior to Christmas. There are companies that try to increase sales in the first half of the year by shipping product at that time and receiving payment at the end of the Christmas season. We firmly believe our strategy of matching product shipments to consumer buying patterns represents a more efficient use of our capital." This was a misleading statement, because as noted in Mr. Forsythe's declaration, WOW had recognized a significant amount of revenue on a dated sale to Toys R Us in an amount of $3.7 million during the quarter ended June 30, 1986. Toys R Us claimed Mr. Kingsborough had agreed to the December 10, 1986 dated terms. (Forsythe Decl. at 12)

B. Deloitte Violated Its Responsibility With Respect To Subsequent Events Up To The Effective Date Of The June 4, 1987 Prospectus

162. An auditor has a responsibility under GAAS to "extend his procedures with respect to subsequent events from the date of his audit report up to the effective date or as close thereto as is reasonable and practicable in the circumstances" (AU 711.10). As a result of these procedures Deloitte was aware of the following facts:

(a) Consolidated net sales for the period April 1, 1987 to May 28, 1987 were *less* than *$7.0* million.

(b) Short-term bank debt had increased to in excess of $82 million at May 28, 1987, while accounts receivable had decreased from March 31, 1987 to May 28, 1987 by approximately $33 million.

(c) "Because of WOW's *tremendous* sales push in March when [approximately] $50 million was sold under special FOB and extended payment terms, retailer probably accelerated potential April sales to take advantage of FOB Program extended terms. Finally lower than budgeted Lazer Tag sales occured in April." (emphasis added). Exh. 26. See DTOO2279.

(d) Accounts payable had decreased by only approximately $4.5 million for the period April 1, 1987 through April 25, 1987. Inventory increased in excess of $13 million.

(e) Additionally, Deloitte was aware of *all* of the facts previously discussed in this declaration.

163. In my opinion, clearly by June 4, 1987, Deloitte had to be aware of the significant and critical financial hemmoraging occuring at WOW. Deloitte should have required revision to WOW's financial statements at March 31, 1987, based upon its additional procedures through June 4, 1987. Pending revision of the financial statements, Deloitte should have modified its report and considered withholding its consent to the use of its report on the audited financial statements in the registration statement. See AU Section 711.

XIV

CONCLUSION

164. In conclusion, the issues raised by plaintiffs regarding the false and misleading financial statements issued by WOW and Deloitte's audit opinions on those financial statements are not an attempt to "second guess" judgements made by Deloitte. The performance of an audit engagement by a professional requires the use of due care, informed judgement and professional skepticism. The selection of audit procedures best suited to each engagement requires the exercise of informed professional judgement and skill. The independent public accountant cannot merely perform audit procedures by rote. The auditor must perform his examination with an awareness that errors or irregularities can occur, which Deloitte failed to do.

165. The accounting and auditing issues involved in this litigation failed to meet the standards of mere common sense and business judgement, much less the standards applicable to an independent public accountant –

GAAS. Deloitte failed to show an understanding of the general business purpose of transactions, an independence in mental attitude and the professional approach good auditing requires. To put it in perspective, auditing requires a knowledge of the business involved, inquisitiveness, a healthy dose of skepticism, due care, and a willingness to take tough stands – in other words, thoughtful, dedicated professionalism that is responsive to the public's interest.

I declare under penalty of perjury that the foregoing is true and correct, and that this declaration was executed at Los Angeles, California, on October 26, 1992.

/s/ Albert Rossi, Jr.
Albert Rossi, Jr.

DAVID B. GOLD,
A PROFESSIONAL LAW CORPORATION
Alan R. Plutzik, Esq.
Gregory C. Moore, Esq.
Steven M. Sherman, Esq.
595 Market Street
Suite 2300
San Francisco, CA 94105

Co-Lead Counsel for Plaintiffs

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF CALIFORNIA

IN RE WORLDS OF WONDER SECURITIES LITIGATION	Master File No. C-87-5491 SC Class Action
This Document Relates To: ALL ACTIONS.	**EXHIBIT A TO THE DECLARATION OF ALBERT ROSSI, JR.** Date: December 11, 1992 Time: 10:00 a.m. Place: Courtroom of the Hon. Samuel Conti (Filed Nov. 10, 1992)

EXHIBIT A

ALBERT ROSSI, JR. C.P.A.

RESUME AND QUALIFICATIONS

I, Albert Rossi, Jr. am managing partner of Rossi and Company a C.P.A. firm located in Los Angeles, California. I have had my own firm since December 1, 1984.

Since December 1983, I have been active in performing litigation support services relating to accounting and auditing matters. My experience includes the following:

- Expert witness in the *FPI/Agretech Securities Litigation* in the United States District Court for the District of Hawaii. Retained by Lieff, Cabraser & Heimann, plaintiffs' class counsel, against Arthur Young and Company. Testified in August 1990 trial regarding professional negligence of Arthur Young & Company in the performance of its examination of financial statements of various entities.

- Expert witness in *Class Plaintiffs vs. Technical Equities Corporation, et al.*, in the United States District Court for the Northern District of California. Retained by David B. Gold, APC and Lieff, Cabraser and Heimann to serve as accounting expert in securities litigation involving financial statement compliance with generally accepted accounting principles (GAAP) and violations of generally accepted auditing standards (GAAS) by Company and KMG Main Hurdman.

- Expert witness in *Creeks USA Corp. v. RGA* in the United States District Court for the Central District of California. Retained by Epstein, Becker, Mulkeen & Green, counsel for Creeks. Testified in August 1990 trial regarding gross revenue derived form the sale of products alleged to have been copied in violation of copyright law.

- Retained by Defense Counsel as accounting consultant, including Parker, Milliken, Clark, O'Hara & Samuelian; Shapiro, Posell & Close; Latham & Watkins; Gibson, Dunn & Crutcher, in *CMA v. Glaser, et al.*, filed in the Superior Court of the State of California for the county of Los Angeles. Case involves numerous accounting and auditing allegations by plaintiff against defendants including Platt Music Corporation.

- Expert witness in *Class Plaintiffs vs. Consolidated Capital Equities Corporation,* Laventhol and Horwath, et al. in the United States District Court for the Northern District of California. Retained by David B. Gold, APC. Litigation involving failure of Laventhol and Horwath to comply with GAAS and failure of financial statements to conform to GAAP, primarily with respect to loan loss reserves.

- Retained as expert witness in *Sachs vs. Ernst & Whinney,* by Mazursky, Schwartz & Angelo. Litigation involves issues of lack of compliance with GAAS by Ernst & Whinney.

- Retained as expert witness in *Class Plaintiffs vs. DeLaurentiis Entertainment Group, Inc., Ernst & Whinney, et al.,* by Greenfield & Chimicles, Milberg Weiss Bershad Specthrie & Lerach, and Barrack, Rodos & Bacine. Litigation involves issues regarding financial statement conformity with GAAP and lack of compliance with GAAS by Ernst & Whinney.

- Retained by Wilmer, Cutler and Pickering, special counsel, for the Cannon Group, Inc. to provide accounting and auditing consultation in response to a Securities and Exchange Commission inquiry concerning the company's financial reporting, disclosures and systems of internal accounting controls.

- *Contemporary Services Corporation vs. Universal, et al.* Retained by Baker and McKenzie as an accounting expert. Case involved alleged violations of Unfair Practices Act regarding rendering services at less than their cost.

- *Class Plaintiffs vs. Micro Pro Corporation, et al.* Retained by Milberg, Weiss, Bershad, Specthrie and Lerach as accounting expert in securities litigation involving financial statement compliance with GAAP.

- *Stephen Palmer, et al. vs. James A. Latham, Touche Ross and Company, et al.* Retained by Munger and Myers as accounting consultant.

- *Quail Gardens Associates, Limited vs. Degen Development Corporation, et al.* Retained by Donald Tremblay, Esq. as accounting expert in litigation involving commingling of funds.

- Retained as accounting consultant in the following securities litigation cases, among others:

  ATV Corporation; Wickes Companies; Nucorp Energy, Inc.; Cousins Home Furnishings; Castle Entertainment, Inc.; Kaypro Corporation; Odetics, Inc.; Xebec Corporation; Tandon Corporation; Seafirst National Bank; Victor Technologies, Inc.; Baldwin-United Corporation; Pace Corporation; Care Enterprises; Heritage Entertainment, Inc.; and Seagate Technology, Inc.

In addition to performing litigation support services, I am still actively involved in providing accounting, audit and consulting services to the firm's clients.

Prior to forming my own firm, I was a partner in the firm of Block, Good, and Gagerman (BG&G) a large local firm of certified public accountants. BG&G had seven partners and approximately forty employees. I was in charge of the firm's accounting and auditing department. I joined BG&G in June 1982 as a manager and was promoted to partner as of February 1, 1984.

Before joining BG&G, I had my own practice which I merged into BG&G. Immediately prior to this, I was an audit manager with Brout and Company, a national firm of certified public accountants. While with Brout and

Company I developed and administered Continuing Education Programs for the Los Angeles office, functioned as Personnel Director for the professional staff, and was coordinator for the Los Angeles office's peer review. In addition, I served as audit manager for a number of public and privately-held engagements.

I received my Bachelor of Science degree in Business Administration-Accounting from California State University, Long Beach, in 1976. I joined the large local firm of Alder, Green and Hasson (AG&H) in Los Angeles upon graduation. At AG&H I received a solid background in all areas of public accounting with a major emphasis is auditing, including SEC engagements. I was a supervising senior with the firm when I left.

During my career as a certified public accountant, I have had primary client responsibility for numerous audit and non-audit/publicly-held and privately-held clients. My experience, in addition to the auditing services, has included: review of credit facilities and banking structure; cash flow forecasting and analysis; financial forecasting and analysis; accounting systems review, development and implementation; management information systems reviews; corporate organization reviews; corporate and individual tax planning and compliance; and acquisition reviews. My industry experience consists of manufacturing – light and heavy; wholesale distributors; service industries; automotive leasing and renting; waste management; alarm service; construction; clearing house; retailing; real estate development; franchising; real estate management and rental; and business management, among others.

In addition to my practical experience, I have also been an instructor for the California State Society of Certified Public Accountants' continuing professional education programs. I have served as a Quality Review Team Captain for the AICPA.

I passed the examination for Certified Public Accounting in 1976 and currently hold a C.P.A. certificate in the State of California. I am a member of the American Institute of Certified Public Accountants and the California Society of Certified Public Accountants.

I also received a Bachelor of Arts degree in Psychology from California State University, San Diego in 1974.

CERTIFICATE OF SERVICE

I, Sharon E. Mortz, hereby declare under penalty of perjury as follows:

I am employed by David B. Gold, A Professional Law Corporation, 595 Market Street, Suite 2300, San Francisco, California 94105. I am over the age of eighteen years and am not a party to this action.

On November 9, 1992, I served a copy of "EXHIBIT A TO THE DECLARATION OF ALBERT ROSSI, JR." on all parties listed on the attached Exhibit I by causing true and correct copies of same to be enclosed in sealed envelopes and deposited in the United States mail (or as otherwise indicated), addressed as shown on Exhibit I.

Executed this 9th day of November, 1991, at San Francisco, California.

/s/ Sharon E. Mortz
Sharon E. Mortz

EXHIBIT I

SERVICE LIST
(No. C-87-5491 SC)

James DiBoise, Esq.
Jared Kopel, Esq.
WILSON SONSINI GOODRICH & ROSATI
2 Palo Alto Square, Suite 900
Palo Alto, CA 94304

Mark Reiff, Esq.
LAPIDUS & REIFF
3 Embarcadero Center, Suite 1020
San Francisco, CA 94111

Joseph J. Tabacco, Jr., Esq.
STAMELL TABACCO & SCHAGER
235 Montgomery Street, Ste. 2510
San Francisco, CA 94104

Stephen T. Rodd, Esq.
ABBEY & ELLIS
212 East 39th Street
New York, NY 10017

Guido Saveri, Esq.
SAVERI & SAVERI
One Market Plaza
Spear Street Tower, 29th Floor
San Francisco, CA 94105

Joseph H. Weiss, Esq.
LAW OFFICES OF JOSEPH H. WEISS
319 Fifth Avenue
New York, NY 10016

Jules Brody, Esq.
STULL STULL & BRODY
6 East 45th Street
New York, NY 10017

Ernest T. Kaufmann, Esq.
KAUFMAN MALCHMAN KAUFMANN & KIRBY
2049 Century Park East, Ste. 1100
Los Angeles, CA 90067

Nadeem Faruqi, Esq.
KAUFMAN MALCHMAN KAUFMANN & KIRBY
919 Third Avenue, 11th Floor
New York, NY 10022

J. Clifford Gunter III, Esq.
BRACEWELL & PATTERSON
2900 S. Tower Pennzoil Place
Houston, TX 77002

Steven E. Greenbaum, Esq.
Melissa Johnson, Esq.
BERLACK ISRAELS & LIBERMAN
120 West 45th Street
28th Floor
New York, NY 10036

William Alderman, Esq.
ORRICK HERRINGTON & SUTCLIFFE
400 Sansome Street
San Francisco, CA 94111

Philip R. Rotner, Esq.
Kristin M. Cappel
McCUTCHEN DOYLE BROWN & ENERSEN
Three Embarcadero Center
San Francisco, CA 94111

Curtis V. Trinko, Esq.
LAW OFFICES OF CURTIS V. TRINKO
521 Fifth Avenue, 10th Floor
New York, New York 10175

Steven Susman, Esq.
Karen Oshman, Esq.
SUSMAN GODFREY
1000 Louisiana, Suite 5100
Houston, TX 77002-5096

Sherrie R. Savett, Esq.
Lawrence Deutsch, Esq.
BERGER & MONTAGUE, P.C.
1622 Locust Street
Philadelphia, PA 19103

Layne E. Kruse, Esq.
FULBRIGHT & JAWORSKI
1301 McKinney
Houston, TX 77010

James Goldberg, Esq.
Michael Kahn, Esq.
FOLGER & LEVIN
275 Battery St., Suite 2300
San Francisco, CA 94111

Robert Skirnick, Esq.
Robert Harwood, Esq.
Daniella Quitt, Esq.
WECHSLER SKIRNICK HARWOOD
HALEBIAN & FEFFER
555 Madison Avenue, 18th Floor
New York, NY 10022

Joel Zeldin, Esq.
DINKELSPIEL DONOVAN & REDER
1 Embarcadero Center, 27th Floor
San Francisco, CA 94111

Marvin Morgenstein, Esq.
MORGENSTEIN & JUBELIRER
101 Market Street, 6th Floor
San Francisco, CA 94105

David T. Hedges, Jr., Esq.
VINSON & ELKINS
1001 Fannin, Suite 3300
Houston, TX 77002-6760

Lew Gravitt
8405 Tiffany Drive
Oklahoma City, OK 73132

Daniel Bergeson, Esq.
Bergeson & Eliopoulous
Ten Almaden, Suite 1245
San Jose, CA 95113

Rice, Fowler, Kingsmill, Vance,
Flint & Booth
Embarcadero Center West
275 Battery Street
27th Floor
San Francisco, CA 94111

ER 516 Ex. 25

ORIGINAL

K MART CORPORATION

INTERNATIONAL HEADQUARTERS
3100 WEST BIG BEAVER RD.
TROY, MICHIGAN 48084

March 28, 1987

AIRBORNE

Mr. Donald Kingsborough
Chief Executive Officer
Worlds of Wonder, Inc.
4209 Technology Drive
Fremont, CA 94538

Dear Mr. Kingsborough:

I am writing to confirm special terms applicable to Blanket Order No. 3, which will be issued to Worlds of Wonder only upon K mart's receipt of a signed copy of this letter and the attached Co-op Advertising Authorization and Specifications form.

1. K mart Corporation (Buyer) will purchase approximately $18,200,000 in Merchandise as specified on Blanket Order No. 3 dated March 28, 1987. The Merchandise will be stored in public warehouses and drawn down by Buyer on an "as needed" basis as follows: Buyer will issue distribution orders to the public warehouse through Worlds of Wonder, Inc. (Seller) from time to time. Seller will oversee the order out of the Merchandise from the public warehouses in order for the Merchandise to arrive at Buyer's "ship to" point by the delivery date specified on each of Buyer's distribution orders. A failure by Seller to cause the delivery date specified on any

distribution order to be met will give Buyer the option of cancelling the Merchandise covered by such order.

2. Title to the Merchandise will pass to Buyer on March 28, 1987; provided, however, risk of loss of or damage to the Merchandise will not pass to Buyer until receipt of the Merchandise by Buyer, from time to time, at Buyer's designated "ship to" points (see also paragraph 7).

3. Buyer will pay the costs of warehousing the Merchandise in public warehouses; provided, however, if such warehousing costs exceed $250,000 or $15,000/month, which ever is greater, Seller will reimburse Buyer the amount of such excess.

4. In consideration of Buyer's early purchase commitment and to assist Buyer in promoting the Merchandise, Seller agrees that Buyer will take a $500,000 deduction against monies due Seller. Seller also agrees that Buyer will take a $250,000 deduction against monies due Seller to cover special handling and inventory charges.

5. Buyer may at its option stock balance any Merchandise shipped under Blanket Order No. 3 which is in its Distribution Center inventory or in the public warehouse inventory on December 31, 1987 on a dollar for dollar basis at the lower of Seller's prices as of March 28, 1987 or Seller's then current prices. Any Merchandise in K mart stores on December 31, 1987 or previously shipped to K mart stores will not be eligible for stock balancing. All stock balancing orders must be issued no later than January 31, 1988 and call for delivery no later than July 31, 1988. Stock balancing orders are limited to Seller's then current product lines. If Seller cannot ship ordered Merchandise by the delivery date specified on the stock balancing order (which date shall be no less

than 30 days from the order date), then Buyer may at its option cancel the order for full credit or refund of the purchase price.

6. All invoices owing by K mart under Blanket Order No. 3 will be passed for payment on December 10, 1987.

7. Seller will pay the freight costs: for the original shipments going into the distribution centers (FOB destination-freight prepaid), for the return of Merchandise being stock balanced (FOB origin-freight collect) and for shipment of stock balancing Merchandise into the distribution centers (FOB destination-freight prepaid). Risk of loss or damage will pass to Buyer, for inbound shipments, upon receipt of the Merchandise by Buyer at Buyer's designated "ship to" points, and to Seller, for outbound shipments, upon Buyer's shipment of the Merchandise back to Seller.

8. Seller will provide counter displays for each new item of Merchandise at all stores at no cost to Buyer and will repair existing store displays at no cost to Buyer.

9. This letter supersedes all prior communications, either written or verbal, with respect to Blanket Order No. 3, including without limitation rough drafts dated March 19, 1987 and April 2, 1987.

10. These terms are in addition to the terms and conditions set forth on the face and reverse of Blanket Order No. 3 and each distribution and stock balancing order issued to Seller thereunder.

11. The attached Co-op Advertising Authorization and Specifications form will apply to all Merchandise ordered under Blanket Order No. 3.

12. Under penalty of perjury, Seller warrants that the allowances granted herein or equivalent alternatives are in fact offered and available on proportionally equal terms to all other competing customers.

Very truly yours,

/s/ T.H. Negolian
/s/ E.J. Scully

AGREED TO as of March 28, 1987 by:

WORLDS OF WONDER, INC.

/s/ Donald D. Kingsborough, Chairman & CEO
By /s/ Angelo M. Pezzani

Title Chief Operating Officer

K mart Corporation

INTERNATIONAL HEADQUARTERS
3100 WEST BIG BEAVER
TROY, MICHIGAN 48084
ORDER CONTRACT
BLANKET ORDER #3

THIS ORDER CONTRACT NOT
AUTHORIZED BY K MART
UNLESS COUNTERSIGNED AT
INT'NAT'L HDQRS.

ORIGINAL
MAIL INVOICE AND BILL OF
LADING TO STORE
GOODS ARE SHIPPED

DATE March 28, 1987
SHIP TO K mart CORPORATION

Vendor Worlds of Wonder

Street 4245 Technology

City Fremont, CA 94538

NOTE – INVOICES FOR SHIPMENTS MADE AGAINST THIS ORDER SHOULD INDICATE ORDER DATE. DATE OF SHIPMENT AND FOR Dept. #4

Shipping schedule and quantities may be changed at Buyer's discretion. This order applies to all Distribution Centers and direct store shipments. Purchase orders will

be sent by Re-buyer for each Distribution Center on an "as needed" basis.

VIA Route Guide

F.O.B. Destination, Freight Prepaid
TERMS Net-December 10, 1987
SHIP To Arrive By Delivery Dates on Distribution Orders
CANCEL at Buyer's Option if Delivery Dates Not Met

ITEM	QUANTITY/ ONLIES	PRICE
Teddy Ruxpin	80,000	$45.78
Grubby	25,000	40.61
Teddy Ruxpin Book & Tape	200,000	7.22
Teddy Ruxpin Clothing	50,000	7.89
Talking Mickey Mouse	50,000	55.90
Mickey Book & Tape	100,000	7.22
Talking Mother Goose	30,000	54.50
Mother Goose Book & Tape	60,000	7.22
Laser Tags	200,000	36.10

ADDITIONAL TERMS AND CONDITIONS

Seller and K mart Corporation ("Buyer") agree to be bound by all terms and conditions contained or incorporated herein, all of which are a part of this Order Contract and should be carefully read. Any provisions in Seller's invoices, billing statements, acknowledgment forms or similar documents which are inconsistent with the provisions of this Order Contract shall be of no force or effect.

1. SELLER'S ACCEPTANCE. Seller's commencement of or promise of shipment of the Merchandise shall constitute Seller's agreement that it will deliver the Merchandise in accordance with the terms and conditions of the Order Contract. Seller agrees to follow the shipping and invoicing instructions issued by Buyer's stores, warehouses, shipping offices and Traffic and Accounting Departments, which instructions are incorporated by reference into this Order Contract.

2. SELLER'S REPRESENTATIONS AND WARRANTIES. Seller represents and warrants to Buyer, in addition to all warranties implied by law, that each item of merchandise described on the face hereof, together with all related packaging and labeling and other material furnished by Seller ("Merchandise") shall (a) be free from defects in design, workmanship or materials including, without limitation, such defects as could create a hazard to life or property; (b) conform in all respects with all applicable federal, state and local laws, orders and regulations, including but not limited to those regarding occupational safety and health; (c) not infringe or encroach upon Buyer's or any third party's personal, contractual or proprietary rights, including patents, trademarks, copyrights, rights of privacy or trade secrets; (d) conform to all of Buyer's specifications and to all articles shown to Buyer as Merchandise samples.

3. SELLER'S INDEMNIFICATION OF BUYER. Seller agrees to reimburse, indemnify, hold harmless and to defend at its expense (or to pay any attorney's fees incurred by Buyer) K mart Corporation and its subsidiary companies against all damage, loss, expense, claim, liability or penalty, including (but not limited to) claims of infringement of patents, copyrights,

trademarks, unfair competition, bodily injury, property or other damage, arising out of any use, possession, consumption or sale of said Merchandise and from any failure of Seller to properly perform this Order Contract. Seller shall obtain adequate insurance to cover its liability under this Order Contract and shall provide copies of the applicable certificate(s) of insurance upon request of Buyer.

4. DEFECTIVE OR NON-CONFORMING MERCHANDISE. If any Merchandise is defective, unsuitable, does not conform to all terms of this Order Contract and all warranties implied by law, Buyer may at its option return it to Seller for full credit or refund of the purchase price or repair it at Seller's expense, and may charge Seller such price or expense and the cost of any incurred inbound and outbound freight and a handling, storage and inspection charge of 7½% of the returned Merchandise' invoice price.

5. BUYER'S RIGHT TO CANCEL. Buyer may terminate and rescind all or part of the Order Contract in the event Seller breaches or fails to perform any of its obligations in any material respect, or in the event Seller becomes insolvent or proceedings are instituted by or against Seller under any provision of any federal or state bankruptcy or insolvency laws or Seller ceases its operation. Time is of the essence to this Order Contract, and Seller's failure to meet any delivery date shall constitute a material breach of the Order Contract.

6. SPECIAL FEATURES. All Merchandise designs, patents and tradenames which are supplied by Buyer to Seller or which are distinctive of Buyer's private label merchandise ("Special Features") shall be the property of Buyer and shall be used by Seller only for Buyer. Buyer may use the Special Features on or with respect to goods manufactured by others and obtain

legal protection for the Special Features including, without limitation, patents, patent designs, copyrights and trademarks.

7. DEDUCTIONS AND SET OFF. Any sums payable to Seller shall be subject to all claims and defenses of Buyer, whether arising from this or any other transaction or occurrence, and Buyer may set off and deduct against any such sums all present and future indebtedness of Seller to Buyer. Buyer shall provide a copy of the deduction voucher(s) for debits taken by Buyer against Seller's account as a result of any returns or adjustments. Seller shall be deemed to have accepted each such deduction unless Seller, within 90 days following receipt of the deduction voucher, notifies Buyer in writing as to why a deduction should not be made and provides documentation of the reason(s) given. Such written notice shall be directed to: Vendor Audit Department, K mart Corporation, 3100 West Big Beaver Road, Troy Michigan 48084.

8. MICHIGAN CONTRACT AND JURISDICTION. This Order Contract shall be construed and enforced in accordance with the laws of the State of Michigan, and it is mutually agreed that either Seller or Buyer shall exercise any right or remedy hereunder in the State of Michigan Courts of Oakland County, Michigan or the United States District Court in Detroit, Michigan.

9. MISCELLANEOUS. (a) All rights granted to Buyer hereunder shall be in addition to and not in lieu of Buyer's rights arising by operation of law; (b) any provisions of this Order Contract which are typewritten or handwritten by Buyer shall supersede any contrary or inconsistent printed provisions; (c) no modification of terms of this Order Contract shall be valid unless in writing and signed by Buyer; (d) should any of the provisions of this Order Contract be

declared by a court of competent jurisdiction to be invalid, such decision shall not effect the validity of any remaining provisions; (e) all of the terms herein shall apply to additional quantities of Merchandise ordered by Buyer except to the extent covered by a new written agreement; (f) the cost price set forth in this Order Contract includes the cost of manufacturing, packaging, labeling and shipping unless otherwise specified herein.

* * *

ER 517 Ex. 27

INTEROFFICE MEMO **WOW**
WORLDS OF WONDER

CONFIDENTIAL

DATE June 29, 1987
TO Angelo Pezzani

FROM Dick Stein
RE **JUNE MPS**

When we signed the June MPS on Thursday of last week, I mentioned to you the financial risk that might arise from this MPS and the recent forecasts of the base and opportunity cases for fiscal 1988. This memo is a follow-up on that discussion in order to give you more specific details for you to take into consideration in your contingency planning.

In both of the forecasts, cash flow requirements in November and December of 1987 and January of 1988 exceed the maximum bank financing available to us under the bank proposals we are presently considering. November is the worst month, where we exceed our bank financing capabilities by $50,000,000. The financing of $63,000,000 of dating is included in the figures. The other financial risk is inventory. If we build inventory to the opportunity sales forecast and only achieve the base case sales, we will end up with $40,000,000 of additional inventory, $135,000,000 in total, at March 31, 1988. We could mitigate this risk somewhat by cutting back our MPS in subsequent months.

With the above in mind, I will start to examine our future financing options.

RBS:bsm

cc: Donald Kingsborough

SIGNATURE /s/ Dick

ER 518 Ex. 97

KMART CORPORATION
INTERNATIONAL HEADQUARTERS
3100 WEST BIG BEAVER RD.
TROY, MICHIGAN 48084

May 6, 1987

Worlds of Wonder
4245 Technology Drive
Fremont, CA 94538

Attn: Mark Bradlee

Dear Mark:

As a follow up to our recent visit, please advise when you think you will be able to sell off the 100,000 pieces of Lazer Tag we discussed at our meeting.

We are most anxious to have our total quantities reduced by this amount due to the lack of movement of the 51,000 pieces we currently have on hand.

Please advise at your earliest convience [sic].

Sincerely,

K MART CORPORATION

/s/ K. A. MacVay
K. A. MacVay, Buyer
Per: G. A. Colgan, Sr. Buyer

KAM:jaq

CC: E. J. Scully
G. A. Colgan
Phil Rosenberg ✔

ER 518 Ex. 99

Toys "R" Us, Inc.
395 West Passaic Street
Rochelle Park, NJ 07662

Howard W. Moore
Executive Vice President
General Merchandise Manager
(301) 368-5440

July 15, 1987

Mr. Don Kingsborough
Worlds of Wonder
4245 Technology Drive
Fremont, California 94538

Dear Don:

This letter is to reiterate the ongoing problems that we are both facing on our inventory.

We are overstocked on the following items:

	Quantity	Last Weeks Sales
1) Talking Snoopy	23,374	49
2) Snoopy Tapes	108,674	165
3) Mother Goose	33,354	307
4) Mother Goose Tapes	231,640	750
5) Laser Tag	193,000	919
6) Laser Tag Accessories:		
– Vest	42,692	139
– Sensor	9,993	177
– Helmet	35,931	70
– Cap	49,453	126
7) Pamela Dolls	28,016	200

8) Pamela Tapes:		
– Camping	5,093	13
– Zoo	8,286	32
– Beach	7,783	43
– Shopping	4,556	13
– Dinner	4,599	19
– BD Party	9,277	49
9) Pamela Outfits	26,493	106

I understand that you are promoting Snoopy and that this situation "may" work its way out. The Snoopy and Mother Goose tapes are a major probem [sic] that will not go away.

The Laser Tag accessories seem hopeless. The Pamela situation has to be addressed for this Christmas, as we discussed.

We would like to take action on these as soon as possible. Please advise me of your latest thinking on these items so we may incorporate any new prices in our roto advertising.

Kindest personal regards.

/s/ Howard
Howard W. Moore

HWM:jmd

ER 518 Ex. 100

(Logo) **Mattel Toys Memo**

TO: Riv Hight
WOW – Hong Kong

DATE: June 24, 1987

FROM: Chris Willson-White

REFERENCE: 022

SUBJECT: LAZER TAG EUROPE

I have just returned from a trip through Europe and was most concerned to hear rumors in all markets of imminent mark downs and subsequent close-out of Lazer Tag in the U.S.

Good trade sources were reporting that WOW has 600,000 Lazer Tag game kits in the U.S. and a further 400,000 Orient commitment, which will result in Lazer Tag being the "close-out of the decade."

Obviously, if you are planning a close-out, we have no objection as far as the U.S. is concerned, but if any of the product reaches International markets, it will have a major detrimental effect on our volume and, of course, kill any profitability.

We had a report that a number of Italian wholesalers had been offered product at a price which would permit a retail price of $25-30 versus our retail of $79.

This situation is worrying and we already face a problem since Photon is being closed-out throughout Europe (in the U.K., for instance, the game kit is already cut from £49.95 to £29.95 . . . with further reductions imminent). This is clearly making us look ridiculously expensive,

and to advertise at the moment would only succeed in achieving sales for Photon.

Riv, I would appreciate your comments and input, since I need to give direction to our Affiliates.

Best regards.

CWW/jmp

cc: Don Kingsborough (WOW Fremont)
Robert Marick
Lindsey Williams

ER 518 Ex. 98

INTEROFFICE MEMO **WOW**
WORLDS OF WONDER

DATE July 6, 1987
TO Don Kingsborough/Bob Goldberg

FROM Ross Heil
RE Lazer Tag Program – Response to Concerned Retailers

The following recommendation is designed to immediately respond to mounting retailer concerns of slow Lazer Tag movement and their substantial inventories.

Objectives

- Maintain current retail pricing, discouraging any serious price cutting
- Build confidence in retailers that we are concerned and are taking immediate action to stimulate movement
- Convince retailers that we have a "grand plan" to make this year's sales even bigger than last.

Strategy

- Select a representative sample of markets as a test and immediately move to increase advertising weights in those markets.
- Follow the test with a heavy-up introduction with new Lazer Tag creative.
- Create a themed selling piece as part of the re-introduction package.

Implementation

- July 8 – Announce test details to all sales reps 3 week heavy weight test in 4 markets
- July 9 – Letters to each major account announcing the test and pledging our commitment
  - Test to begin week of August 3rd. ("It will take us that long to purchase time/coordinate test")
- July 15 – Sales letter to all major accounts:
  - Media schedules by market
  - Toy Tracs study results (graphic/charts) showing desire for Lazer Tag

SIGNATURE /s/ Ross Heil/MK

  - Summary of reports showing increased sales of Lazer Tag at numerous accounts
- August 3 – Begin airing 300 GRP's in test markets end of that week, entire following week and through mid week of following week. (2 weeks over 3)
- August 10 – Report to key retailers of results from first week (repeat for next 2 weeks)
- August 17 – Report #2
- August 24 – Report #3
- August 31 – Complete test results Break plans for major Fall launch:

- New Lazer Tag commercial, "Hotter than ever!"
- Media plan reflecting 4 week intro weights @ 300 GRP's based on test results
- Full color sales brochure with complete program details including:
  - media schedule through the end of 1987
  - Promotion programs with college tournaments and Boys Clubs of America
  - Semi-spectacular display suggestions

- September 12 – National PR event to re-focus attention on Lazer Tag
- September 15 – New commercial begins to air at 300 GRP's

NEXT STEPS: I propose a Re-intro Team be organized with one member each from: Sales, Product Management, Manufacturing, Administration and Graphics/Point of Sale. The Team will need to:

- Implement and monitor each element of the plan
- Recommend program changes based on market response
- Prepare a weekly status report to management
- Coordinate and provide to Sales detailed material for their communication with retailers

I believe that a weekly dialogue with retailers, and our reps, will demonstrate our dedication to the task.

Please let me know if you'd like to discuss this proposal in greater detail.

Thanks

RFH:mk

cc: Janice Kimball, Dave Ruckert, M. Bradlee, A. Pezzani

(ATTACHMENTS TO THE MEMORANDUM)

(Logo) ***TSC Top Sales Company, Inc.***

June 30, 1987

Mr. Dave Ruckert FEDERAL EXPRESSED 6/30/87
WORLDS OF WONDER
Graybridge Division
4209 Technology Drive
Fremont, California 94538

Dear Dave:

Mike Vann at Rose's is very upset with us. When we had the meeting in New York, you told Rose's you would get back with them to set up the Lazer Tag Test in Florence, South Carolina, and Bluefield, West Virginia.

As of this date, he has not heard anything from any of us, and we need to do something. Rose's has a serious overstock on Lazer Tag, and Don Kingsborough made the commitment to find out what TV would do.

I would appreciate it if you would get back to us so we can let Rose's know something.

Sincerely,

TOP SALES COMPANY, INC.

/s/ Felix S. Sabates
Felix S. Sabates

FSS/bd

cc: Mark Bradlee
Jim Whims
Sal Morabito

INTEROFFICE MEMO **WOW**
WORLDS OF WONDER

DATE July 1, 1987
TO Bob Goldberg

FROM Dave Ruckert
RE Summary of Action Items/Mini-Toy Fair

Following summarizes actions promised at the mini-Toy Fair meetings:

1. **Lazer Tag**

A. **Roses** – Two small city tests of high level media (250-350 GRP's/week) full in-store, one at $29.95 and one at current $39.95.

ACTION: Decision to only run at $39.95 must be communicated to Roses through Sal Morabito. Market(s) must be selected and media test implemented.

B. **Lionel Leisure** – Requested high level media test in one of their markets.

ACTION: If WOW agrees to test, market must be selected and test implemented. Co-ordinate through Sal.

C. **Walmart** – Tulsa selected for media/T-shirt test by them 6/30/87. They will buy time and bill us.

ACTION: Co-ordinate through Mike Needleman. Price to be rolled back to $39.95 by Walmart.

D. **Target** – Won't order Lazer Tag line extensions until current product starts to sell.

ACTION: I suggest using a Target market for a media heavy up this summer.

E. **Circus World** – Very upset about Lazer Tag. I was with another account during DK discussions with them.

ACTION: Find out if DK promised media or promotion test, but seems like a good idea to include a CW market for heavy up media.

SIGNATURE _____

ER 519 Ex. 101

(Logo)

BRENNAN
HOWARD

REPRESENTING LEADING
MANUFACTURERS

June 19, 1987

Mr. Carl Crosier
Worlds of Wonder, Inc.
1313 Lyndon Lane
Suite 109
Louisville, Kentucky 40222

Dear Carl,

Per your request, please find our "First Quarter Goal Recap" attached. As you can see, we have been able to move some July orders up for June shipment.

However, following are a few comments in response to your last few memos:

1) First of all, why didn't we know until the 3rd week in May that we had a first quarter quota?

2) Somebody has their head in the sand if they think, as your last memo states, that product is "in demand at this time of year". It is true that merchandise is still selling; however, not at Xmas time rates. I don't think we (WOW) alone are going to change the toy buying habits of the consumer.

3) We should not have to remind you that we have more than enough inventory already out at retail. For example, following are inventory levels and sell-thru numbers on key items at Gold Circle:

ITEM	5/31 INVENTORY		MAY SALES	
Lazer Tag	21,838	Units	164	Units
Teddy	10,647	"	84	"
Grubby	3,062	"	18	"
Teddy Books & Tapes	29,814	"	67	"
Teddy Clothes	5,470	"	87	"
Moother [sic] Goose	2,376	"	9	"
Mickey Mouse	5,754	"	9	"

BRENNAN and HOWARD, INC.
3030 W. Market St., Akron, Ohio 44313
(215) 867-7550